PRINCIPLES OF AUDITING

F. R. M. DE PAULA, F.C.A.

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A PRACTICAL MANUAL FOR STUDENTS AND PRACTITIONERS

BY

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PREFACE

THE subject of Auditing is so vast, that the standard works, of necessity, are somewhat lengthy and cumbersome books, and a considerable part of the matter contained therein is intended for practitioners only. This book has been written primarily for students, with the object of providing a book of convenient size, and at a reasonable cost, that will deal with all the general principles that govern every audit; and so form a stepping-stone to the larger works.

I have endeavoured to cover the whole of the groundwork with which every student of auditing must be familiar and to explain the principles and reasons underlying each subject dealt with. On the other hand, owing to lack of space, I have omitted specialised subjects, such as the different classes of audits and investigations; for if all these were included, the whole book would have had to be condensed so considerably, that it would have been impossible adequately to discuss the important root principles that apply to every audit. For the same reason all the various Acts of Parliament to which auditors have at times to refer, have been omitted, but the sections of the Companies (Consolidation) Act, 1908, with which every auditor must be familiar, have been included.

The appendix contains one hundred examination questions, which run in order with the text of the book, and it is thought that these will prove of value to students for the purpose of testing their knowledge with a view to preparing for examinations.

I would take this opportunity of thanking most sincerely Mr. Herbert Jacobs, B.A., Barrister-at-Law, and Mr. David W. Coates, M.A., LL.B., A.C.A., for the very valuable assistance that they have afforded me.

I shall appreciate greatly any suggestions or opinions from readers, whom I hope this little book may assist to acquire a thorough and practical knowledge of the principles of auditing.

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THE PRINCIPLES OF AUDITING

CHAPTER I

INTRODUCTORY

THE science of auditing can be traced back over many centuries, but it is only within recent years that the full benefits that are derived from a periodical audit have begun to be appreciated fully by the commercial world. The great expansion of the world's trade has had the effect of considerably complicating business transactions; again, the whole trend of modern business is towards the formation of large concerns controlling large volumes of trade, with the result that the small businesses are gradually disappearing. It has, therefore, been found absolutely essential that the proprietors of a business shall have some means of checking the transactions carried out by their employees, and also that they may be certain that the accounts laid before them are accurate, and in fact do show a true and correct view of the state of the affairs of the business. To fulfil these requirements, a body of specially trained professional auditors and accountants has come into existence, and this has led to the enormous and rapid growth of the accountancy profession which has taken place during the last twenty or thirty years. There can be no doubt that this expansion is destined to continue, not only in this country but all over the world, as the commercial community realises the necessity, and appreciates more thoroughly, the benefits of, an audit.

1—(1524)

Difference between Accountancy and Auditing.

In former years the work of professional accountants was confined chiefly to the checking of the arithmetical accuracy of the detailed records of transactions in books of account, the agreement of the Trial Balance, and the preparation of accounts ; in fact to what may be described as "Accountancy Work," but nowadays, the all-important part of a professional accountant's work is that of auditing. The difference between accountancy and auditing is not clearly understood by many business men, it being thought that if accounts are prepared by a professional accountant, he necessarily guarantees their accuracy. This, however, is far from being the case. If an accountant is instructed merely to prepare accounts from a set of books, the work involved would be that of agreeing the Trial Balance, and thereafter preparing the Profit and Loss Account and the Balance Sheet. He would be acting simply as an expert accountant, and not in any way as an auditor ; he would not check the books themselves, except as far as would be necessary to agree the Trial Balance, and he would not certify that the position shown by the Balance Sheet was correct : all he could say would be, that the Balance Sheet was in accordance with the books. Accountants, as experts, are often called upon to deal with figures in this way, but when doing so, they should be particularly careful to point out to their clients that they are not carrying out an audit. And they cannot certify a Balance Sheet as being correct, unless they have conducted a proper audit of the whole of the transactions of the business.

An audit is quite distinct and apart from accountancy—an audit does not entail the preparation of the Balance Sheet at all, but denotes something much wider, namely, the examination of a Balance Sheet prepared by others, together with the books, accounts and vouchers relating thereto in such a manner, that the auditor may be able to satisfy himself and honestly certify that, in his opinion,

such Balance Sheet is properly drawn up so as to exhibit a true and correct view of the state of the affairs of the particular concern, according to the information and explanations given to him, and as shown by the books.

An audit of a Balance Sheet involves the verification of the Profit and Loss Account, as the balance of that account must be included in some form or other in the former, and it entails a detailed examination of every item in the Balance Sheet. The Balance Sheet, however, is the all-important document, and is the one to which, in the case of a company, an auditor's report refers and to which it is often affixed, for the Balance Sheet contains in summarised form all the balances appearing at a given date in a set of books kept by double entry, including the balance upon the Profit and Loss Account, after the nominal accounts have been closed by transfer to this latter account. The whole of the transactions of a business should be recorded in its books of account, and the combined effect of all such transactions and the whole financial position of the concern, should be reflected in the Balance Sheet; and the primary object of an audit is that there may be an independent investigation with a view to ascertaining whether or not such Balance Sheet shows a true reflection of the financial position of the concern.

In practice, auditors often do prepare the Balance Sheet and Profit and Loss Account, which accounts they thereafter certify; but it must be observed that, when preparing the accounts, the accountant is acting *qua* accountant and not *qua* auditor, and that this work is additional to and quite outside his duties as auditor. The duty of an auditor is to check and report upon the completed work of others.

Main Objects of an Audit—Detection of Errors and Fraud.

The two main purposes of an audit are the prevention and detection of errors and fraud. Errors may consist

of clerical errors, either of commission or of omission, and errors of principle. Errors of commission are comparatively simple to discover, as the ordinary routine checking of the books should disclose them. Under this head will be included incorrect postings, castings, and calculations; mistakes in posting and casting will affect the agreement of the Trial Balance, and their presence will thus be revealed, although the actual detection of the various errors that make up the total difference in the books may entail a considerable amount of detail checking. This work can be considerably reduced in large businesses if self-balancing ledgers are introduced, as in this way it may be seen at once in which ledgers the errors occur. There is no way of exactly locating the errors, except by checking the castings and postings until the discrepancies are discovered. Errors in calculations often will not be revealed by the audit, for such mistakes will not affect the agreement of the books: for example, if by a mistake in the working out of prices, the wrong amount be extended in the Sales Day Book, this total will be included in the casting up of the Day Book, and hence eventually will find its way to the credit of the Sales Account, while the same amount will be posted to the debit of the customer's account in the Sales Ledger, and so the Trial Balance will not be affected. In the ordinary way, it is not considered to be part of an auditor's duty to check the whole of the calculations of the Sales and Bought Day Books, but he should ascertain that these are all independently checked by the staff of the business whose accounts he is auditing, and he should test some of the calculations here and there, in order to satisfy himself that the internal check is being carried out. Important calculations such as those dealing with depreciation, reserves, interest on capital, loans, mortgages, etc., however, should be checked.

Errors of omission are far more difficult to discover than errors of commission, as the former will not affect the agreement of the Trial Balance; such errors will

include the omission to enter invoices in the Bought Day Book, the omission of sales from the Sales Day Book, the non-provision for interest, rent, salaries and other such outstanding accounts. Although the discovery of such omissions, which point will be dealt with at some length later on, forms a very important part of the duty of the auditor, yet in a large business he is compelled to rely to a certain extent upon the internal checks in the business itself to assist him in the performance of this part of his duty. If, however, his audit programme is complete and is thoroughly and efficiently carried out, most of such omissions should be discovered. Errors of omission made intentionally, may affect the results shown by the accounts very considerably, and so constitute a fraudulent falsification of such accounts.

3. Errors of principle may be committed purposely or accidentally, and may affect the accounts considerably; if intentional, they may amount to falsification of accounts, but, on the other hand, they may arise quite unintentionally through lack of a correct knowledge of the principles governing the preparation of the accounts of a business. Hence it is necessary that an auditor should have an extensive knowledge of accountancy, and should make a most thorough investigation if he is to discover such errors, which will include, for instance, the incorrect allocation of expenditure as between capital and revenue, the valuation of assets upon an incorrect basis, and the inadequate provision for depreciation and bad debts. In this connection it must be borne in mind that, as a rule, no amount of routine checking will disclose errors of principle—these can be discovered only by intelligent enquiry and research. Errors of this nature may make an enormous difference in the accounts, whereas, the effect of clerical errors probably will be very small.

The detection of errors is a very important part of an auditor's duties, as in this way the proprietors of a business may feel confident that the accounts are accurate, and that

the position of affairs is clearly shown; but by far the more important part of the auditor's duties is, the detection of fraud, and its prevention by means of the moral check created by a periodical audit. This is the main reason for his appointment in the majority of cases; for instance, the Companies (Consolidation) Act, 1908, provides that every company shall appoint an auditor, who shall audit every Balance Sheet that is laid before the shareholders. The reason is not that the shareholders necessarily suspect the directors of preparing fraudulent accounts, but that the shareholders as a body have no means of ascertaining how the business is being carried on and what is the financial position of their company, except by reference to the accounts submitted to them by the directors, who conduct the business as the representatives of the shareholders. The shareholders, therefore, would be entirely in the hands of the directors, who could make the accounts show whatever position of affairs they chose, unless such accounts were checked independently on behalf of the shareholders. It is for this reason that an auditor is appointed, who acts on behalf of the shareholders, and is absolutely independent of the directors whose accounts he audits. The main object of his appointment is to satisfy the shareholders that no fraud is being committed by either the directors or the employees of the business. It must not be thought that an auditor should adopt an attitude of suspicion during the conduct of his audit; in fact he should endeavour to avoid creating a spirit of hostility and mistrust between himself and the directors and staff of the company. Above all things, he should be tactful. His position is that he is there to ascertain that everything is in order, that it is this duty to his employers which he must carry out. He need, therefore, adopt no attitude of mistrust; the shareholders are adopting an ordinary business precaution, and have appointed him to see for himself that the accounts are in order in all respects, and thereafter he has to report to the shareholders to this effect; or, in the event of his

not agreeing that the position shown is the true and correct one, he must state this fact in his report, giving his reasons.

Fraud may take the form either of the misappropriation of cash or goods, or the falsification of the accounts unaccompanied by misappropriation. Misappropriation of cash may be concealed either by omitting to enter receipts, or by entering fictitious payments. In order to discover the first, the auditor must check the receipts shown in the Cash Book with original records, such as till books, salesmen's desk books, cash diaries, counterfoil receipt books, agents' returns, etc.: only by comparing original records with the cash accounted for in the Cash Book can such discrepancies be revealed. Fictitious payments will be discovered by a careful examination of vouchers, invoices, wages sheets, and other direct evidence of this nature. Misappropriation of goods is more difficult to detect, unless accurate stock records are kept; in fact, unless such records are in use, it is almost impossible to discover small misappropriations of this nature. That losses of stock are taking place may be indicated by fluctuations in the percentage of gross profit to sales, but this will not locate the fraud itself. The falsification of accounts, unaccompanied by actual misappropriation, is usually far more difficult to discover, as this is generally perpetrated by directors or managers who wish to bolster up the concern by showing fictitious profits in order to pay dividends, to obtain further credit, to increase commissions due to themselves, or with a view to the disposal of their holdings in the company at high prices. In such cases, as the fraud is committed by responsible and trusted officers of the company, an auditor must be particularly vigilant if he is to discover it, as probably he will be given intentionally false information and explanations. He can, therefore, only discover such frauds by the exercise of considerable care and skill, and by making most exhaustive enquiries and research.

Routine Checking.

It must be observed that the mere routine checking of an audit will only disclose clerical errors and very simple frauds, and will seldom, if ever, reveal errors of principle or clever frauds. In order to discover these, the auditor must go behind the actual books of account and examine original records, and make intelligent enquiries; in fact, he must go to the foundations upon which the books have been built up. In the following chapters, an endeavour is made to show the lines upon which an auditor must work in order to discharge his duties, but at the outset it cannot be too strongly emphasised that an auditor must avoid becoming submerged in the detail and routine work of an audit. He must be constantly vigilant; he must not take things for granted, but must in all cases satisfy himself on every point by making proper enquiries. He must work upon a definite and intelligent plan, constantly bearing in mind the weak spots in the system of book-keeping in respect of which errors or fraud are most likely to occur. Although it is impossible to discover a clever fraud or important errors of principle if the audit consists purely of what may be called "tick work," this routine checking is of the utmost importance, and, in fact, represents the foundations upon which the audit is built up; but if the audit is backed up by nothing else, probably only clerical errors will be discovered.

The routine checking in an audit is apt to become very monotonous and, consequently, somniferous; but it is most essential that it should be done thoroughly and intelligently. This part of the work often devolves upon the junior members of the auditor's staff, and they should endeavour to think out exactly what part the checking that they are engaged upon takes in the whole plan of the audit, what are the likely errors or frauds that might take place, and how these latter would be detected by the checking. In this way the work will become far more interesting, and if the junior has any natural aptitude, he

will soon commence to gain a grasp of the principles of practical auditing, an acquisition which is bound to advance him in his profession, and one, moreover, which will make his work more and more absorbing, in a way probably that at the commencement would have been thought impossible.

Extent of Auditor's Investigations.

It is not sufficient for an auditor merely to compare the Balance Sheet with the books of account, but he must go, to a certain extent, behind the books. Errors of principle and fraud, as a rule, will not be discovered upon the surface, but will be detected only by investigations outside the actual books that form part of the system of double entry. The auditor, therefore, must use every reasonable care and precaution in order to satisfy himself that the books themselves are correct, and include all the transactions that should be recorded therein. Therefore, the extent to which an auditor must carry his investigations is a very important practical question, and of necessity it must depend largely upon the whole of the circumstances of each case. In a small business, where there is no proper internal check, the auditor must check practically all the items in detail and verify a considerable proportion of them by reference to the original records, Where, for instance, there is a head book-keeper who has control of all the books and who is assisted by a few juniors, the head book-keeper, having access to the whole of the books, can make adjusting entries, and has every opportunity to cover up a fraud. If, then, he is skilful, it will be almost impossible to detect such fraud by mere routine checking of the books.

Internal Checks and the Auditor's Position in regard thereto.

In a large business, where there is a staff of some numbers engaged upon the books, it is quite a simple matter to organise a system of internal check that may relieve the

auditor of a considerable amount of detail checking, and thus limit his investigations behind the books themselves to occasional tests. An internal check means practically a continuous internal audit carried on by the staff itself, by means of which the work of each individual is independently checked by other members of the staff. For example, the clerks in charge of the ledgers should not keep, or be allowed to make entries in, the books of first entry; on no account should the cashier be allowed to have any control over the ledgers. A system of self-balancing ledgers may be made to form a very valuable part of the internal check, as also may automatic tills for checking cash receipts, and time-recording clocks for checking wages. Where there is an efficient system of internal check, it is very difficult for any extensive fraud to take place except as the result of collusion between various members of the staff. Internal checks do not make fraud impossible by any means, but they make it more difficult and the chance of detection much greater, and, therefore, act as a valuable moral check. The auditor should investigate the whole system, and when checking the books pay special attention to any weak points; he should also satisfy himself that the internal checks are carried out, and he should test this by checking here and there, haphazard. If the system is an efficient one, an auditor may rely thereon to a considerable extent as regards a large part of the detail work, and thus will have more time to devote his attention to the more important parts of the audit.

The extent to which an auditor may rely safely upon internal checks and omit to check the whole of the detail entries, depends entirely upon the whole of the circumstances of the particular case, and this question must be decided by each auditor for himself. In this direction he requires considerable skill, experience, and judgment, and the efficiency of his audit will depend largely upon the skill with which he deals with this question.

Commencement of New Audit.

Before commencing a new audit, an auditor should ascertain, by reference to statute, or from the instructions received from those employing him, precisely the scope of his duties. He should next acquaint himself with the exact nature of the particular business, and make himself familiar with the technical details of the various transactions. If, for example, he is to audit the accounts of a factory, if it be possible he should ask to be shown over the factory, as in this way he will see and appreciate what is the nature of the transactions that are recorded in the books, and he will understand roughly the process, and the nature of the machinery, materials, and labour involved. This knowledge will enable him to exercise a much more complete grasp of affairs, and he will appreciate the essentials much more readily than would be the case if he saw no further than the counting-house.

The next step should be to obtain a list of all the books of account, and the names of the clerks in charge of each, after which he should thoroughly investigate the whole system of book-keeping and the internal checks, if any, in vogue. In any large business, the detail involved will be enormous, and the auditor must, therefore, consider carefully the whole system, in order that he may decide what ground his investigations must cover, and how far, and in what directions, he can rely upon the internal check. His endeavour should be to see that the system is such that every transaction does become properly recorded in the financial books, that there is no possibility of items being omitted or altered purposely or accidentally, and that no fraudulent entries can be made. The auditor should also study any legal documents governing the concern, such as the Articles of Partnership in the case of a partnership, the Memorandum and Articles of Association in the case of a company, any contracts with vendors and others, special Acts in the case of Parliamentary companies, the will or settlement in the case of a trust. He should

make notes of the clauses that are likely to affect the accounts, and with the terms of which he must be familiar during the course of the audit.

Audit Programme.

If the audit is to be an annual one, during the course of the first year the auditor should prepare, or supervise the preparation of, an audit programme, in which should be recorded the exact details of the work to be performed by the auditor and his staff, columns being provided in order that the persons performing each part of the checking may initial as and when they complete the same. Thus, it will be seen that in this way the principal, or his responsible clerk, maps out the exact scheme of the audit in the first place, after carefully considering the whole of the circumstances of the case. He may then be certain that the audit staff will cover the whole of the necessary ground, and if, in future years, different members of the staff are engaged upon the audit, they can see by reference to the programme exactly what work they are required to perform, and further, the principal can see at any time what part of the work has been completed, and what remains to be done. In a large practice, unless some such method is adopted, the principals must of necessity lose a very large amount of control, and will be very much in the hands of their staff; and, in fact, the efficiency of the audit will depend, not upon the skill and competency of the principals, but upon the skill and competency of the member of the staff in charge of the particular audit.

There is one objection to this mode of procedure, and that is, that the clerks in charge may lose a sense of responsibility, and carry out the work in an automatic manner. It should be impressed upon them, therefore, that the programme set out is the basis upon which the audit is to be conducted, and that they must use their intelligence when carrying out the same, and they should be encouraged to recommend additions and improvements

in the scheme, for it is most important, as time goes on, that the scheme should be kept constantly up to date, as otherwise serious flaws may develop. For this reason, it is important that the principals should reconsider the programme from time to time.

Notes during Audit.

The question as to what notes an auditor should make during the course of an audit is one upon which there is some difference of opinion. All unimportant queries and mistakes should be settled and adjusted as they occur, and it is not necessary to make notes thereof; but notes should be made of all important questions that arise, and of all important verbal instructions and information given by the management. Notes should be made of all missing vouchers, invoices, etc., all queries that have not been settled and adjusted, and all matters that have to be remembered from one visit to another. Again, all working papers should be filed and kept, as also should the drafts of accounts, and the schedules appertaining thereto. In this way, should questions arise in the future, the auditor would be in a position to show exactly what work he performed, what queries he raised, what explanations and information he received, and by whom these latter were given. The importance of this will be appreciated later, when the question of an auditor's liabilities is considered. It must be remembered, that should anything go wrong, probably it will be years after the work was actually performed, when perhaps those who were actually in charge are no longer available, so that, if proper records were not kept, the auditor might find himself in a position of some considerable difficulty.

Method of Work.

As regards the actual methods to be adopted when conducting the work of an audit, the common practice is for accountants to adopt special and distinctive ticks for

the different classes of transactions that are checked, such as special ticks for castings, cross castings, carry forwards, postings, vouchers, pass book, contras. These ticks should be as distinctive as possible, and a rule should be made that similar ticks are not to be used by the staff of the concern whose accounts are under audit. Naturally, the meaning of the various ticks should not be explained to clients or their clerks. On no account should junior audit clerks allow themselves to be drawn into discussing their work with the employees of the firm whose accounts they are auditing, as the object may be to ascertain whether there are any weak points in the scheme of the audit, which may be taken advantage of for the purpose of concealing frauds. Many auditors use different coloured inks for the different periods, as in this way the entries of each period stand out clearly.

When calling back, audit clerks should be most careful to speak clearly, as otherwise mistakes may easily be passed. For example, £70 6s. 3d. may be posted £76 3s., and, in order to avoid this mistake when calling back, the "ty" should be emphasised thus, "Seven*ty*-six-three," or this amount should be called back as, "Seventy *pounds*-six-three." All bad figures and alterations should be carefully examined, and it should be seen that the same figure is taken both in casting and posting. On no account should erasures with a knife be allowed, and an invariable rule to this effect should be made. Some auditors adopt a special tick in the case of altered items, so that it may be seen afterwards whether alterations were made before or after the items were ticked. Another good plan is for the auditor to write the correct figure in at the side of any altered and indistinct figure, as this often saves mistakes.

Whenever possible, an auditor should refuse to commence checking the books until they have been completely written up for the period, and on no account should he check figures that are entered in pencil. Each stage of the work should be completed at one sitting, if possible ; for example,

if checking the Cash Book vouchers for a month, the whole should be checked off, and notes made of all missing vouchers—otherwise, if the work is left incomplete, and the books are in the hands of the clients' staff in the meantime, a most dangerous loophole is provided. Each part of the work should, therefore, be completely checked, records being kept of the exact points to which the checking has been carried, unless the books are in the entire control of the auditor during the whole time of his audit. The risk of the books being tampered with during the audit should always be borne in mind, and preventive precautions taken.

After the postings of any book have been checked, the same should be scanned for unticked items, and these should be carefully investigated.

The checking of additions is a very mechanical task, but it is important that this should be carefully and accurately done. It is extremely easy to pass mistakes when checking additions, unless care is taken, and a good plan is to cover the total when casting up the column until after the total has been arrived at. In this way it is almost impossible for errors to be missed.

Continuous and Periodical Audits.

Audits may be continuous or periodical. A continuous audit is one where the auditor attends at regular intervals during the period of the accounts, say monthly or quarterly, checking the books to date as far as possible. A periodical audit is one where the auditor does not attend until the end of the period of the accounts, when the whole of the checking is effected at one time.

The advantages of a continuous audit are, that mistakes are discovered soon after they have been committed, when they can be rectified easily, the whole of the circumstances being in mind. The opportunities for fraud are lessened when the auditor attends at short intervals, and his frequent attendances act as a valuable moral check, and

keep the book-keepers up to date with their work. Again, should fraud take place, it should be discovered before it has attained large proportions. As the auditor is not pressed for time, he can carry out a much more detailed audit than is possible when the whole of the work has to be accomplished at one time. At the end of the period, as the greater part of the detail checking will have been completed, the auditor will be able to finish the audit soon after the accounts are prepared. By means of a continuous audit, the auditor is kept in constant touch with the business, thus obtaining a knowledge of what is going on, and, therefore, he is less likely to overlook important points, than is the case if he attends, say, only once a year. As the work is spread evenly over the year, it will probably suit the auditor's own arrangements far better than if he has the whole of the work to perform at one time.

The chief disadvantage is that items may be altered after the auditor has checked them, and this danger should be recognised and special precautions taken, as suggested previously, such as special ticks for altered items, and the checking completely through of each part of the work. This danger is not entirely eliminated in the case of a periodical audit taking some days to complete, as the book-keepers generally have access to the books during the absences of the auditor, when it is quite possible that alterations might be made. These dangers can only be avoided by the auditor adopting systematic methods, and being constantly vigilant.

Difference between the Position of Auditors Appointed under Statute, and by Private Individuals or Firms.

The difference between the position of an auditor whose appointment is under statute, and where he is appointed by a private individual or firm, should be noted carefully. For example, an auditor appointed under the Companies

Acts, 1908 to 1917, is acting as the agent of the shareholders to audit the accounts of the directors, who are merely the servants of the shareholders. His powers and duties are defined by statute, and it is his duty to carry out those duties completely. He must act absolutely independently of the directors, although that does not mean that he must adopt an attitude of mistrust or suspicion—in fact, he should do nothing to engender a hostile attitude ; but, should serious questions of principle arise, he must be absolutely fearless, and, having made up his mind as to what is his duty in the circumstances, he must do it, regardless of any pressure the directors may bring to bear. The auditor's powers and duties are defined by statute, and cannot be taken away, nor in any way limited, by either the directors or the shareholders.

On the other hand, an auditor appointed by a private firm is not appointed under any statute—he is merely acting for the partners, and he must carry out such instructions as he may receive from them. The great importance of this arises where he is not instructed to carry out a complete audit, but merely to carry out a partial audit, and then (as is generally the case) to prepare the accounts of the firm. Sometimes an accountant is requested to prepare the accounts, but is not instructed to conduct any audit of the books at all. In such circumstances, therefore, he has no power, nor has he any right, to insist upon carrying out a full audit, and his duty is to carry out faithfully and to the letter the exact instructions he has received—in other words, what he has contracted to do, for the partners may limit the scope of his work in any way that they may please. But, when an accountant receives instructions to carry out a partial audit, or to prepare accounts only, invariably he should see that his instructions are recorded in writing. If he arranges matters verbally with his clients, at the interview he should ascertain exactly what it is that they require him

to do, and he should explain to them that he can accept no responsibility outside the work covered by his instructions. Thereafter, and before commencing the actual work, he should write a letter to his clients, exactly setting out the terms of the arrangements made, emphasising any limitations, so that if questions arise in after years, he may be in a position to show exactly what were the terms of the contract, and, therefore, for what he was and for what he was not responsible. In order to save expense, clients often arrange for a partial audit, but they do not appreciate that the auditor's liabilities are reduced accordingly. If, therefore, anything goes wrong—for instance, if an employee has been defrauding them—they may blame the accountant and seek to hold him responsible. Now, in such circumstances, it will depend entirely upon what the accountant contracted to do, as to whether or not he is responsible. The question will be this: Having regard to the work he contracted to do, should he have discovered the fraud? If the original contract is not in writing, the accountant will be in a very difficult position indeed, for in all probability his clients will say that the understanding was that he should cover the particular ground, whereas, he rightly may say that he never received instructions to do that part of the work, and thus it will be a case of one word against the other. But if, as suggested, the original arrangement had been in writing, no such difficulty could have arisen, as the exact scope of the work undertaken could be ascertained at once, by reference to the correspondence.

Some firms of accountants make it a custom, in the case of partnerships, to write a report with every Balance Sheet, in which attention is drawn to any points of importance, and also to the fact that the Balance Sheet has not been, or has been only partly, audited, and at the foot of the Balance Sheet a reference is made to this report, such as: "The foregoing Balance Sheet is to be read in conjunction with our report of such and such a date." There

is much to recommend this procedure, as accounts are constantly being produced to third parties for various purposes, such as obtaining credit, loans or advances. Accounts are often furnished in this way to intending partners or purchasers of the business, and to others who have entered or propose to enter into business relations with the firm. Such persons may be seriously misled by the production of accounts bearing a professional accountant's name, and which they may be informed have been audited by him, whereas, in fact, this may not be the case. If the above course were adopted invariably, the accountant's position would be absolutely secure in the case of difficulties arising with his principals or with third parties who have acted upon the accounts without reference to his qualifying report.

Qualifications of Auditor.

The qualifications required by an auditor are many and varied. First of all, he must have an absolutely complete and thorough knowledge of book-keeping and accountancy, as an auditor in course of time is called upon to deal with many different systems of book-keeping in many different businesses, and unless he understands exactly how such accounts should be prepared, he cannot check them; therefore, he must be complete master of his subject, and thus be able to apply his knowledge to any set of circumstances. He must thoroughly understand practical business, and be able to grasp the technical details and the business methods of any concern whose accounts he is called upon to audit. A knowledge of accountancy is essential, but that alone will not make a competent auditor, for the science of auditing is quite apart and distinct from accountancy. Many beginners seem to think that, provided they are able to follow the system of book-keeping and that the Trial Balance agrees, everything must be in order, and the auditor has only to check the preparation of the Profit and Loss Account and Balance Sheet, and to sign his

report. The agreement of the Trial Balance proves nothing, except the arithmetical accuracy of the books. An auditor requires a considerable legal knowledge, and must be complete master of the principles of auditing in all its bearings. In addition to his scientific knowledge, he must be above all things a man of affairs, and possess tact and character; he must not be easily led and influenced by others, but knowing what his duty is, he must be able to do it in spite of direct or indirect pressure. He may find himself in positions when his duty to his client is opposed to his own interests, and in such circumstances he must have the courage to carry out his duty faithfully, regardless of the effects it may have upon himself. In the long run, the reputation he will thus gain for absolute integrity will prove of far greater value to him than any temporary loss in the first case. An auditor must be methodical and painstaking, and he must be endowed with considerable perseverance, for much of the work is of a somewhat mechanical nature, but it is essential that the whole should be thoroughly and carefully done. He must never pass any item unless he understands its nature and is absolutely satisfied that it is in order; if he is not, he must make intelligent and exhaustive enquiries until he has ascertained the exact state of affairs. One of the greatest dangers is to pass entries which are not completely understood, because the auditor is fearful of displaying ignorance by asking questions. If he cannot ascertain for himself, he should, without fail, ask for the necessary information, for should he affect to possess knowledge which, in fact, he does not, he inevitably will make mistakes that will be far more damaging to his reputation than would be the case if he asked for information upon, for instance, technical details of which he has not had previous experience. An auditor must be practical, and if asked for professional advice, must appreciate the practical requirements and circumstances of the business, and thus avoid making recommendations which, though perhaps

theoretically perfect, are entirely unfitted to the circumstances of the particular business. But it must be noted, that it is no part of an auditor's duty to give advice unless it is asked for, though in practice his advice is generally much appreciated if it is given tactfully; however, he cannot insist upon his recommendations being carried out. But if, for example, the system of book-keeping be so deficient that it is impossible to prepare accurate accounts, then he would be bound to report upon the unsatisfactory state of affairs.

In the foregoing chapter the general principles upon which an audit should be based have been set out at some length; in the subsequent chapters it is proposed to describe the detail work of an audit, and the various questions and difficulties that constantly arise in practice.

CHAPTER II

ROUTINE CHECKING AND VOUCHING

Checking Castings and Postings.

THE checking of castings and postings forms a considerable part of an audit, and though this work is somewhat mechanical, it is very important that it should be carefully and intelligently carried out. The extent to which the auditor will take his checking in this direction, depends upon the system of book-keeping and internal checks in vogue. In the case of small businesses, where there is practically no internal check, the whole of the castings and postings should be checked—in these cases, too, the auditor is often instructed to balance the books, and, consequently, it will be found necessary in all probability, to do this checking for this purpose. The balancing of the books and the preparation of the accounts are not part of an auditor's duties, though in practice he often is requested to carry out this work, and it must be remembered that if he does so, he is acting *qua* accountant. In the case of a large business, where there is an efficient internal check, and the books are balanced by the staff of the concern, it is not necessary or usual to check the whole of the castings and postings. These are tested by checking a proportion only, but some judgment is necessary in deciding what to do and what not to do, the circumstances of the particular case being all-important, and it is impossible to lay down any hard and fast rules. However, assuming a proper internal check and that the books have been balanced, the following is an outline of the checking that would be carried out by a cautious auditor.

CASH BOOK. The whole of the castings and postings should be checked, but if self-balancing Sales and Bought Ledgers are in use, the Cash Book being provided with

analysis columns for this purpose, it may be sufficient if the totals of the Sales and Bought Ledger cash are checked into the total accounts, and a proportion only of the detail postings checked to the Personal Ledgers. But invariably the whole of the Impersonal Ledger postings should be checked, in order that the auditor may ascertain that all these items have been posted to the correct accounts. The checking of these latter items should never be done mechanically, but the nature of each should be observed, especial care being exercised with all amounts debited to capital accounts, no such entries being passed until the auditor is satisfied that the same are in order, and are properly dealt with in the books.

SALES AND BOUGHT DAY BOOKS. The auditor should check the totals to the Impersonal Ledger and to the total accounts, if kept, and a proportion of the detail castings and postings.

RETURNS AND ALLOWANCES BOOKS. The totals should be checked to the Impersonal Ledger and to the total accounts, and a large proportion of the detail castings and postings should be checked, each item being scrutinised.

PETTY CASH BOOK. The whole of the castings and postings should be checked, both the postings from the Cash Book to the Petty Cash Book, and those from the Petty Cash Book to the Impersonal and Personal Ledgers.

POSTAGE BOOK. If there is a proper internal check, it will be sufficient if occasionally the amounts drawn from petty cash are checked into the Postage Book, and the castings of this latter book checked. It is very common to find small defalcations in connection with postages, and, therefore, this book should not be lost sight of, but should be called for at odd times, and a portion carefully checked.

JOURNAL. All the castings and postings should be checked, no item being passed until the auditor is satisfied that the same is correct in every particular.

TRANSFER JOURNAL. The totals should be checked to

the total accounts (if any) and a proportion of the castings and postings should be checked.

WAGES AND SALARIES BOOKS AND STOCK SHEETS. All the castings of these should be checked, unless the auditor is satisfied that they have been checked completely and independently by the staff of the particular concern, as it must be remembered that there is no double entry check upon these totals.

BILLS RECEIVABLE AND PAYABLE BOOKS. The detail here will not be very great, so that the whole of the castings and postings can be checked—the totals being checked to the total accounts if the ledgers are kept upon the self-balancing system.

SALES AND BOUGHT LEDGERS. The whole or a considerable proportion of the castings of the above should be checked, and all the balances should be checked on to the schedules of balances as at the date of the accounts, and if the ledgers are self-balancing, it should be seen that the totals of the various lists of balances agree with the balances upon the respective total accounts.

IMPERSONAL AND PRIVATE LEDGERS. All the castings and balances of these ledgers should be checked, while at the same time each account should be carefully scanned for unticked items, which should be most carefully investigated, and on no account ticked as having been passed accidentally by one of the audit staff, unless the auditor is absolutely certain that such is the case. In any event, notes should be made of any such unticked items, as in the event of the books not balancing, it may be discovered that upon further investigating these entries, differences may be found.

The foregoing checking is based upon the assumption that there is an efficient internal check, and that the Cash Book, Personal Ledgers, Impersonal Ledgers, and books of first entry are all under separate and independent control. If this is not the case, the checking will have to be carried further, and in this connection the auditor must exercise his judgment and experience, but it is a

wise policy to err on the side of over-checking rather than under-checking. An auditor should not endeavour to do as little checking as possible, but rather to do as much as he can.

Differences in the Balancing of Books, and the Detection thereof.

It sometimes occurs that the staff of a business is unable to balance the books, and the question arises whether an auditor in any circumstances can pass accounts in which there is an undiscovered difference. In the case of a small business, where the detail involved is not great, a difference should be discovered; but in a case where the detail involved is very heavy, a small difference may be passed, provided that the auditor is satisfied that the books have been so far checked that it is practically impossible that the discrepancy represents the combined effect of several mistakes. There is considerable danger in passing a difference in the agreement of a set of books, even though it is small, for unless the books have been checked exhaustively and properly, there may be errors involving large amounts on both sides, the difference between which gives rise to the discrepancy, and these errors may affect the accounts considerably, or might even represent frauds. If the ledgers are kept upon self-balancing principles, no difference should ever be allowed to remain undiscovered upon the Impersonal and Private Ledgers, but only upon the Sales and Bought Ledgers, and even in the latter cases, this should be permitted only when, owing to pressure of work, the staff cannot afford the time to look for the difference, such difference being small in amount, and the books having been checked already extensively. Where there is an adequate staff, there should be a rule that all ledgers must be agreed, otherwise the ledger clerks are apt to become careless and slack; further, the ledgers should be agreed at as short intervals as possible, as in this way the magnitude of the task of balancing them is reduced.

Accountants are often instructed to balance books, and this is sometimes an arduous and laborious task, in the carrying out of which considerable care and method is necessary, especially in cases where the books have been badly kept. If the ledgers have been kept upon the self-balancing system, it will be seen at once in which ledgers differences lie, and it will be necessary merely to check the details of these particular ledgers until the errors are discovered. But where this system is not in force, the field is much wider, and the task may be far more troublesome. One of the first things to do would be to check the balances of the various ledgers on to the Trial Balance and the schedules of debtors and creditors. Thereafter, the castings of the Trial Balance and the schedules should be checked, when the exact difference will be ascertained. When checking the ledger balances, the castings of the accounts should be checked, as also should the bringing down of the balances. At the same time it should be seen that the totals of the two sides of each account in fact do agree; errors are easily passed if this is not the case. If the whole of the postings have been checked already and ticked, each ledger account should be scanned for unticked items, as also should the books of first entry. All bad and doubtful figures should be re-checked and made clear. It is sometimes possible, from the amount of the difference, to gather some idea as to the probable nature of the same. For example, a difference of 10s., £10, £100, is probably an error in a casting or carry forward. If the difference is divisible by two, it may be an item posted to the wrong side of a ledger account, for instance, a difference of £14 8s. 4d., representing an excess of debits over credits, may be accounted for by an amount of £7 4s. 2d. having been posted to the debit instead of the credit of an account. The books should, therefore, be scanned for items of this amount. Differences are often caused by figures being entered in the wrong columns, such as 5s. 4d. posted as £5 4s., in which case

there would arise a difference of £4 18s. 8d.; or £170 6s. 3d. posted as £176 3s. It should be calculated whether any such mistake will give the amount of the error, and, if so, any such item should be looked for, and, if found, checked. Any amounts exactly equalling the difference should be checked, as they may represent a single entry for which there is no corresponding credit or debit, as the case may be. Often in practice, the time spent in trying to find the difference by these " short cuts " is time wasted, and the only way is to continue checking until the errors are revealed.

After the balances have been checked as suggested above, it is sometimes a good plan to check completely the castings and postings of the Impersonal and Private Ledgers, and possibly also the Bought Ledger, in which the detail, it may be, is not great. If the error is not discovered, it will be necessary thereafter to turn to the Sales Ledgers. It is well to have the castings of the books of first entry checked, but in the case of the Cash Book, if this has been agreed with the Pass Book, it may be unnecessary to check the castings. If the difference is still undiscovered, the accountant will have to check the postings of the Sales Ledgers, until the cause of the discrepancy is brought to light. Some accountants prefer to call back postings from the ledger to the books of first entry, thus completely checking each ledger account, at the same time checking the castings and the balance on to the schedule of balances. When checking balances, it is as well to check the opening balances with the schedules of the previous period, as the difference may be accounted for by an error in bringing down the commencing balances.

As a last resort, it is sometimes necessary to analyse the ledgers, in order to discover in which ledger the difference arises, and also in what direction it lies. This means analysing each ledger account under various headings, upon specially ruled analysis paper. For example, in the

case of a Sales Ledger the columns on the debit side would be as follows—

Opening balance ;
Goods debited ;
Sundry items ;
Transfers ;
Total ;

and the headings on the credit side would be—

Cash credited ;
Discounts ;
Allowances and Returns ;
Bad Debts written off ;
Bills Receivable ;
Transfers ;
Sundry Items ;
Closing Balance ;
Total.

The cross cast of each sheet will prove that arithmetically the analysis is correct, and that the ledgers have been cast correctly. The total of the opening balances should agree with the list of the previous period, the total of the goods debited should agree with the total sales as shown by the Sales Day Books—if there is a difference, it must represent errors in posting or casting. In the same way, the totals of the allowances, etc., and bad debts can be agreed. By analysing the Cash Book, the total cash and discounts credited to the Sales Ledger can be agreed with the totals according to the analysis of the ledger. Owing to the time and labour involved, it is doubtful, except in extreme cases, whether it is worth while to analyse the ledgers in this way, and whether, instead of doing so, it is not better at once to commence checking the ledger postings, etc., as, on completion of the analysis, the actual mistake is not discovered, but only the fact that it lies somewhere in a certain ledger, and in a certain book of prime entry; for instance, that it is in the posting of the sales, in which

event, the postings of the sales will have to be checked until the error is found.

Vouching.

Vouching is the very essence of auditing, and the whole success of an audit depends upon the intelligence and thoroughness with which this part of the work is done. Vouching does not mean merely the inspection of receipts with the Cash Book, but includes the examination of every transaction of a business, together with documentary and other evidence of sufficient validity to satisfy an auditor that such transaction is in order, has been properly authorised, and is correctly recorded in the books. By this means the auditor goes behind the books of account and traces the entries to their source, and it is in this way alone that he can ascertain the full meaning and circumstances of the various transactions; for if he confines himself to the entries as they appear in the books of account, his information will be incomplete, and he may pass matters of the utmost importance, which affect the accounts very materially. The entries in the books show only such information as the book-keeper chooses to disclose, and such information may be purposely or unintentionally contrary to the true facts—therefore, only by examining external evidence can an auditor possibly ascertain the real state of affairs. An auditor is blindfold who does not base his audit on thorough and efficient vouching. In most cases clever frauds can only be discovered by vouching, so that it is essential that this part of an audit should be conducted with great care and intelligence.

When checking vouchers, a special tick, or, better, a rubber stamp, should be impressed upon the document inspected, and this cancellation of the voucher should be distinctive, as the object is, that the same may not be produced again in support of another item. It is well to denote, by the place where the voucher is marked, the

purpose for which it has been taken, as, for example, an invoice may be produced twice to the auditor, once when vouching the Bought Day Book, and, subsequently, if receipted, when vouching the Cash Book. The entry in the books should be ticked in a distinctive way when the corresponding voucher has been accepted.

Whilst the original vouchers are before the auditor, he should make careful note of various matters to which attention will have to be paid subsequently, or of any subsidiary information derivable from the documents. Such cases will include when further information or authority is required, or when additional documents such as contracts, Articles of Association, or minutes have to be inspected. When examining vouchers for rent, rates, taxes, insurance, commissions, salaries, etc., the period covered by the payment should be scrutinised, and notes made of any apportionments and outstandings that will have to be provided for at the end of the period. Other information may be noted, such as the purchase prices of important materials, this information being most valuable for the purpose of verifying the prices at which such materials are taken into stock. By such methods the re-examination of documents is obviated, and time is thereby saved.

Cash Book. Before settling his programme for vouching the Cash Book, an auditor should enquire carefully into the whole system of internal check (if any) that is in force with regard thereto. The following suggestions show the lines upon which such enquiries should be made—

(1) Has the cashier control of any of the ledgers or books of first entry? If so, special care should be taken in this direction, since the opportunities for fraud are thereby increased considerably.

(2) Who opens the letters, and are all cheques and postal orders immediately crossed to the clients' bankers, and also marked "account payee only"?

(3) Who enters the cheques and moneys received into

the paying-in book, and who actually pays into the bank ?

(4) Are all receipts banked daily ?

(5) Who makes out and sends off the receipts for moneys received ?

(6) What control is kept upon unused receipt books ? Are they kept under lock and key, and issued only when current books are used up completely ?

(7) Is a rough Cash Book kept, and who writes up the Cash Books ?

(8) How often, and by whom, is the Cash Book agreed with the Pass Book ?

(9) What internal checks are there as regards cash sales and miscellaneous income ?

(10) Are travellers or agents allowed to collect debts due to the concern ? If so, to what internal checks are they subject, and what records and returns do such travellers or agents make ?

(11) How are invoices and accounts received, checked and passed for payment ?

(12) Who draws the cheques ? Are the cheques which are drawn in payment of accounts crossed prior to signature "not negotiable" and "account payee only" ?

(13) Who controls the despatching of the cheques and covering letters ?

(14) Who checks the receipts for payments with the Cash Book, and how are such receipts filed ?

(15) Who makes out the statements, and who controls the despatch of the same to debtors ?

(16) Who posts the entries from the Cash Book to the ledgers ?

Upon the completion of this investigation, the auditor will draw up the scheme of his audit of the Cash Book, paying special attention to any weak points in the system, and all places where, from his experience, he sees that loopholes are likely to be found. He should point out

to his clients any weaknesses in the system, and, although it is no part of his duties, in practice probably he would advise them as to the manner in which the system could be improved and strengthened. There are two main objects of such a system. The first is to ensure that all the receipts of the business from all sources are accounted for, and, therefore, every precaution should be taken, by means of internal checks, to make it as difficult as possible for the receipts to be misappropriated. The second is to ensure that no improper or fraudulent payments are made, that every payment has been properly authorised and is a *bonâ fide* business expense, that the transaction is properly recorded in the books of account, and that the payee actually has received the amount.

Banker's Pass Book. One of the first steps in vouching the Cash Book should be the checking of the same with the Banker's Pass Book. The individual items in the Cash Book should be called back with the Pass Book, both the Cash Book and Pass Book entries being ticked, and the reconciliation statement at the end of the period should be checked, thus agreeing the Cash Book and Pass Book balances. The cheques, both paid in and drawn, that are not through the Pass Book at the date of the accounts, and which appear in the reconciliation statement, should be traced through into the Pass Book for the succeeding period, in order that it may be seen that such outstandings are *bonâ fide* transactions which do appear in the Pass Book, though in the following period. If the audit takes place some time after the close of the financial period, and there are outstandings that are still not through the Pass Book, enquiries should be made as to the reasons. When checking the debit side of the Cash Book with the Pass Book, it should be seen that the dates agree—except in the case of country cheques, which may not be credited in the Pass Book for a few days—because many frauds are committed by the simple expedient of delaying the banking of moneys, the defaulting person having the use of such

moneys in the meantime, and thus always being in possession of part of the funds of the concern.

When checking the credit side of the Cash Book with the Pass Book, it should be seen that the dates and names in both correspond, and that all bank charges, dishonoured cheques, etc., have been entered in the Cash Book. In cases where the Pass Book has been checked already and agreed by the staff of the business, and a reconciliation statement is placed before the auditor, some accountants merely check the credit side of the Cash Book in total, though, even in such circumstances, the whole of the debit side should be checked in detail, all contras being noted, enquired into, and taken into account when agreeing the credit side in total. Should the auditor have to prepare the reconciliation statement, he will tick off the Pass Book items with the Cash Book as indicated above, and thereafter he will scan the Cash Book for unticked items on both sides—these should represent items not yet through the Pass Book. From the Pass Book balance should be deducted the total of the cheques drawn, but not yet paid by the bank, and to this amount should be added any cheques paid in but not yet credited in the Pass Book. The result thus obtained should give the Cash Book balance. In the case of an overdraft, the process will have to be reversed.

Frauds have been covered up in the past by producing to the auditor a dummy Pass Book, and, therefore, in order to guard against this, the auditor should obtain direct from the bankers a certificate of the balance according to the books of the bank, as at the close of the financial period of the concern whose accounts are being audited, and it must be seen that this balance agrees with the balance shown by the Pass Book produced.

Vouching Debit Side

The vouching of the debit side of the Cash Book is the more difficult of the two, as the auditor is not so much

concerned with the entries that appear, as with the possibility that receipts have been omitted; consequently, he is thrown back upon the internal checks, and indirect evidence.

Paying-in Book. If the counterfoils of the Paying-in Books have been initialled by the bank, a proportion of such counterfoils should be checked with the Cash Book; the object of this is to ascertain that the whole of the moneys received has been paid into the bank promptly, and also that cheques have not been split improperly. The splitting of cheques may arise in this way. A payment by A. B. & Co., of (say) £50 in settlement of their account is misappropriated, and, consequently, does not appear in either the Cash Book or A. B. & Co.'s account in the Sales Ledger. If it is left in this state, after a time attention would be bound to be directed to this unliquidated account, and on application being made to A. B. & Co. for payment, the fraud would be discovered immediately. Therefore, in order to cover this up, a later cheque from another debtor, C. D. & Co., for £100 is entered in the Cash Book as A. B. & Co. £50, and C. D. & Co. (on account) £50, and the cheque of £100 is paid into the bank. In this way, A. B. & Co.'s account is closed and the defalcation is transferred to a new account and thus for a certain length of time the accounts may be manipulated. A comparison of the counterfoils of the Paying-in Book may reveal this fraud, unless the production of the counterfoils to the bank for initialling when paying in has been omitted; in which latter case, the counterfoils may have been made to agree with the Cash Book by the cashier. In cases where fraud is suspected, the auditor should endeavour to obtain from the bank the original paying-in slips in its possession, and these he should check with the Cash Book.

Receipt Books. The counterfoils of Receipt Books may be tested with the Cash Book, though if this check is anticipated, the defaulting party may make them agree with the Cash Book—for this reason Receipt Books with

carbon impressions are to be preferred to the counterfoil system, as the former are more difficult to manipulate in this way. It must also be seen that precautions are taken to prevent blank receipt forms being obtained. In the same way, travellers' receipt books and collecting books should be tested with the cash accounted for by them according to the Cash Book.

Cash Received from Debtors. The best check upon the cash received from debtors is to arrange that those who collect and handle the cash can in no way control the preparation or sending out of the statements; if, for example, statements are sent monthly in respect of every open account on the ledgers, any misappropriation of cash received is almost certain to be discovered, as the debtor, on receipt of the statement, will at once draw attention to the fact that credit has not been given for the payment he has made.

Cash Sales. In the case of Cash Sales, an auditor is largely dependent upon the system in vogue. If automatic tills are used, the till records should be tested with the cash accounted for under this head. In large shops the salesmen should not be allowed on any account to receive the cash, but should make out a bill, carbon impressions being taken automatically, and upon this bill the customer should pay to a desk cashier, who should record such takings in a Desk Cash Book. When such a system is in use, the counting-house staff should prepare daily summaries of the cash sales from the Salesmen's Desk Books, and these totals should be checked and agreed with the desk cashier's summaries, and with the total of cash sales paid into the bank, and in the same way the auditor should check a proportion of the cash sales. If there is no system, or if what system there is is bad and faulty, it is impossible for an auditor to vouch the cash sales, and in such circumstances he should point this out to his principals in writing, and disclaim all responsibility in this connection until an efficient system is put into force.

Miscellaneous Receipts. Miscellaneous Receipts are somewhat difficult to check, and the evidence required depends upon the nature of the items. The following are examples, together with the methods by which an auditor should vouch the same—

Rents Receivable. The counterpart leases and agreements with the tenants should be examined, and in this way the exact amounts receivable ascertained. The amounts due will then be checked to the rent-roll, if one is kept. The rents received according to the Cash Book should be checked to the rent-roll (if any) and with agents' accounts, if the rents are collected by agents. All empties and arrears should be carefully enquired into. In the case of weekly properties, sometimes each tenant has a rent book in which the collector enters and initials for the amounts received. In such cases, the auditor should occasionally call for the production of such books, and see that all the rents entered therein have been accounted for.

Interest and Dividends. Interest and dividends received from investments should be checked with the counterparts of the interest and dividend warrants, or the letters covering the cheques. In the case of bonds, the bonds themselves should be inspected, and it will be seen by the coupons that have been torn off what interest should have been received. If the bonds are in the hands of the client's bankers, the bankers collecting the coupons when due, the entries in the Pass Book will be a sufficient voucher. The auditor must see that all the dividends or interest in respect of every investment have been received and accounted for.

Interest on Deposit. Interest on Deposit will be vouched with the entry in the Pass Book.

Commissions Received. Commissions received will be vouched with the Commission Accounts rendered.

Amounts Received From Agents. Amounts received from agents will be checked with the accounts rendered by

the agents, which accounts should have been checked and passed by the management.

Interest on Loans. The loan agreement or whatever other evidence there is of the loan should be inspected, it being seen that the interest there provided for has been accounted for.

Bills Receivable. The amounts received should be checked to the Bills Receivable Book, it being seen that all bills due have been accounted for.

Proceeds of the Sale of Investments. Proceeds of the sale of investments should be checked with the stock-broker's contract note, which will show the net amount to be received.

Proceeds of Sale of Sundry Assets. Proceeds of sale of sundry assets will be checked with whatever evidence is available. In the case of a sale by auction, the amount received should be checked with the auctioneer's account and a marked catalogue. In other cases, the correspondence, contract of sale, and any other documents in connection therewith must be examined, in order to ascertain the amount of the sale price.

Amounts Received under an Insurance Policy. Such amounts should be checked by means of the correspondence with, and accounts rendered by, the insurance brokers or the insurance companies.

Subscriptions. Subscriptions received by a club or society should be checked with counterfoil receipt books, and with the published list of subscribers.

Vouching Credit Side

Receipts, etc. The majority of the documents produced in connection with the vouching of the credit side of the Cash Book, will consist of receipts, invoices, and receipted accounts, and when examining these, an auditor should compare the name of the payee with the name in the Cash Book. He should note the dates upon the account, for in this way it may be found that accounts that should have

been charged to the Profit and Loss Account of the previous year are being borne by the year under review. On the one hand, such a mistake may have been accidental, in which case it should be seen that proper precautions are taken that no such mistakes are made in the future; or, on the other hand, it may be discovered that there has been fraudulent suppression of accounts in the past, and that thus the profits have been inflated. The dates should also be scrutinised, in order to guard against the vouchers of back years being produced in support of fraudulent payments in succeeding years. The particulars of goods supplied or services rendered should be scrutinised, with a view to ascertaining that the same are proper business charges, and that the private accounts of individuals are not being paid by and charged to the business—therefore, the name of the party to whom accounts are addressed should be examined. If private accounts are paid through the business, as sometimes occurs in order that the individual may obtain the benefit of trade terms, it should be seen that the amount is debited to that person's account in the books.

The amount of each voucher should be compared with the amount in the Cash Book, it being seen that any discounts have been properly dealt with in the books. The auditor should see that the account has been initialled as having been checked and passed for payment, and that the proper account in the ledger is debited therewith. In the case of receipts, if the invoices of the creditor state that only official printed receipts will be recognised, then no other form of receipt should be accepted without full enquiry. Receipted invoices should be scrutinised with especial care, as it is very simple for *bonâ fide* invoices to be fraudulently receipted by the cashier; for this reason receipts upon creditors' printed receipt forms, and those bearing the creditor's rubber stamp, are far better evidence than an invoice or account merely receipted in ink. All receipts for amounts of £2 and over should bear a penny

stamp, and the auditor should point out any that are not so stamped, though he cannot refuse to accept such a receipt upon this ground only, if otherwise he is satisfied with the voucher, as all the auditor requires is evidence of payment and that the transaction is in order, and this is not affected by the mere non-stamping of a receipt.

Some businesses send with remittances their own form of receipt to be completed and returned by the payees, and there is a growing practice to have a form of receipt printed at the foot or upon the back of the cheque forms. In both of these cases such receipts are very unsatisfactory ones from an auditor's point of view, as no particulars are given as to the nature of the payment, and they are not good evidence that the payee has received the amount, as there is considerable danger that such receipt forms may be completed fraudulently, and such fraud is extremely difficult to detect. Where such receipts are produced, the auditor should insist that the corresponding invoices or accounts should be attached, so that he may see the particulars and verify that the payment is in accordance therewith.

Contra Accounts. Accounts settled by contra account should be traced, the best voucher being a subsequent statement of account which confirms the settlement.

Payment of Bought Ledger Accounts. In the case of payments in settlement of Bought Ledger accounts, the invoices will have been examined when vouching the Bought Day Book, and, therefore, it will not be necessary to call for these again when vouching the Cash Book, the creditors' receipts being sufficient. In the case of payments that are debited to Impersonal Accounts, however, mere receipts are not sufficient, but the auditor must insist upon the production of invoices and accounts, giving full particulars of the transaction, so that he may see that the same are in order ; further, he may have to refer to minutes, contracts, and other similar evidence, before he can pass

such payments. This part of the vouching of the Cash Book payments requires great care.

ENDORSED CHEQUES. Notes should be made of all missing vouchers, and in cases where these cannot be found, the auditor should insist upon duplicates being obtained. In such cases, the endorsed cheques often are produced to the auditor, in lieu of a receipt, but these should not be accepted as vouchers, except in special cases. An endorsed cheque is not a legal receipt, it affords no evidence as to the nature of the payment, nor is it good evidence that the payee has received the amount, as the endorsement may be forged. The only circumstance in which endorsed cheques might be considered sufficient vouchers, is when the signature of the payee is well known to the auditor, and there is other evidence as to the nature of the payment, that it is in order, and that it has been duly authorised, examples being, directors' fees, salaries, and partners' drawings. Even in such cases, however, proper receipts should be obtained, if possible, and it is advisable, with regard to partners' drawings, that the partners should be requested to examine their respective drawing accounts periodically, and, if they find them to be in order, to initial the same.

CAPITAL EXPENDITURE. Capital expenditure should be most carefully vouched, with a view to ascertaining that the payments are in order, and are proper capital charges. The question as to what documents will be required depends upon the nature of the payment. The following are examples—

PLANT, MACHINERY, FURNITURE, FIXTURES, ETC. Invoices and receipts will be required, and enquiry should be made in order to ascertain that the items are *bonâ fide* capital charges, and that no repairs and expenses of maintenance are added to the capital account.

LAND AND BUILDINGS. The contract of sale and the solicitor's statement, showing the purchase consideration payable should be seen. If the buildings are being erected,

the auditor should examine the builders' contract, the builders' receipts, and architects' certificates. The title deeds should also be inspected. Solicitors' and architects' charges will be vouched by their receipted accounts, and these expenses may be treated as being part of the capital cost.

Investments. If purchased through a stockbroker, the contract note should be inspected, and this will show the exact amount payable. In the case of a new issue, for which application has been made, the allotment letter and banker's receipts for the instalments paid should be inspected, if these have not yet been exchanged for the certificates. The share certificates, bonds, etc., will also have to be examined when verifying the assets.

Wages. The question of wages is one of very great importance in the case of many manufacturing businesses, and it is essential that there should be a most complete internal check in this direction. The auditor should carefully examine into the system of recording and paying wages, and if it is bad and faulty, he should point out its shortcomings and disclaim responsibility, for in such circumstances it is impossible to prevent, or be certain of detecting, frauds. The lines upon which a wages system should be based are as follows—

The times of time-workers should be recorded by means of time-recording clocks, and it is important that responsible officials, such as foremen, should see the hands ring in and out upon the clocks, as, otherwise, late arrivals may get their earlier comrades to ring in for them.

The times of each employee, as shown by the clock records for the week, should be entered in the Wages Book by one wages clerk, and the rates of pay inserted by another. The amounts should then be calculated, all deductions such as National Insurance contributions, fines, subscriptions, etc., made, and then the Wages Book should be cast. The whole of this work should be independently checked, the clerks taking part in each stage of

the preparation and checking of the Wages Book initialling for what they have done.

In the case of piece-workers, as the work is given out and taken back by the foreman, particulars should be entered upon piece-work cards or sheets, which should be initialled by the piece-worker and the foreman. These cards or sheets should be handed in to the wages office at the end of the week, the particulars being entered up in the Wages Book and independently checked as in the case of the time-workers.

When complete, the Wages Book should be handed to the cashier, who should have no control over the actual preparation of this book. The cashier should proceed to draw and cash a cheque for the exact amount of the week's wages. He should then place the exact amount due to each wage-earner in a little bag or can bearing the individual's name or number, after which the Wages Book and the cash thus sorted should be handed to some responsible official, who should pay the workpeople as they leave the works, foremen who know the employees being present to identify them. The cashier and the person paying the wages should initial the Wages Book, which should thereafter be returned to the wages office.

The above is but a brief sketch of a wages system, but the basis upon which every system should be built up is, that the records in the works, the preparation of the Wages Book, the checking of the same, the handling of the cash, and the payment of the wages, should be under entirely separate and independent control. The principals of the business should watch the wages system carefully, and occasionally either take part in or watch the actual payment of the hands.

After investigating the system, and assuming that it is an efficient one, the auditor should check the Wages Book as follows—

Check the castings and a proportion of the calculations;

Check the weekly totals of the Wages Book with the cheque drawn as shown by the Cash Book;

See that the Wages Book has been initialled by all taking part in the various stages;

Occasionally test the system by calling for the time records and piece-work cards for a week, and checking these with the entries in the Wages Book.

Salaries. A Salaries Book should be kept in which the weekly or monthly salary of every salaried official and clerk should be entered. The book should be ruled with columns in which the actual payments are entered. The auditor should check the cheques drawn with the Salaries Book, which latter should be initialled by a partner or director. All alterations in the salaries payable should be confirmed in the same way.

Travellers' Commissions and Expenses. A book should be kept for each traveller, in which should be entered the monthly amounts due for commissions and expenses. In some cases, travellers are allowed a fixed amount for travelling, but where they are allowed to charge their actual expenses, vouchers should be insisted upon for all expenses, except such as railway fares, etc., for which no receipt can be obtained. Where this latter method is adopted, the expenses should be carefully watched and checked by the management. When the travellers are paid, the amounts should be entered in the traveller's book, which should be receipted by him. The auditor should check these books as far as possible, and vouch the cheques drawn, according to the Cash Book, with the travellers' books, seeing that the latter have been receipted, and that all unpaid commissions and expenses are brought into account at the end of the financial period.

Petty Cash. Petty cash should be kept upon the Imprest system, by which the petty cashier is given a round sum which is estimated to be sufficient to cover his expenses for the ensuing week or month, as the case may be. At the end of this period, the petty cashier should balance

his book and produce it to the cashier, who should check and vouch it, and, if it is in order, hand the petty cashier a cheque for the exact amount of the total disbursements for the period. The Petty Cash Book should be ruled with analysis columns, in order to save a number of postings to impersonal accounts. Vouchers should be insisted upon for all payments above, say, 5s., and in cases where it is impossible to obtain receipts, dockets should be made out, giving details of the expenditure, and such dockets should be initialled by the person actually expending the money. On no account should anyone, other than the petty cashier, have access to the petty cash, and clerks should not be allowed to borrow from petty cash. On the last day of the financial period, all cash balances in hand should be paid into the bank, and on the first day of the ensuing period, the petty cashier should be given a cheque for the agreed fixed round sum. The only sums utilised for petty cash should be the cheques drawn specially for this purpose—all sundry small receipts should be paid into the bank and passed through the Cash Book.

The auditor should carefully enquire into the system of petty cash, and report if it is weak or faulty. He should check the castings and postings, and the cheques drawn from the Cash Book into the Petty Cash Book. He should see that the book has been initialled by the cashier, and he should check at least a proportion of the vouchers, at the same time observing the nature of the payments, and the heads under which they are analysed. If the balance at the end of the period has not been paid into the bank, the auditor should count the cash in hand and agree it with the balance shown by the Petty Cash Book. If this is not done at the date of balancing, the book should be checked to the date at which he attends, and the balance then counted and checked with the Petty Cash Book balance at that date.

POSTAGE BOOK. The auditor should see that there

is an efficient internal check upon the postages, and he should check this book occasionally, checking the amounts drawn from the Petty Cash Book into the Postage Book, and counting the balance in hand, if the amount is large.

CHAPTER III

VOUCHING (*continued*)

Bought Day Book.

THE whole system as regards ordering goods, checking invoices, and authorising payment, should be investigated by the auditor, as, if strict control is not exercised in this direction, the opportunities for fraud are very great. The question whether a really effective system can be evolved depends upon the staff available, and if there is no system, or there is a bad one, an auditor should exercise considerable care, and check exhaustively the Bought Day Books and Ledgers.

All orders should be made out on specially printed and numbered order forms bound up in Order Books provided with carbon leaves, so that every order issued is duplicated automatically. Orders should be made out and initialled by the head of the department requiring the goods, and countersigned by a responsible official, such as a partner or director.

A Goods Inwards Book should be kept at the entrance to the works, and as goods are delivered, the quantities and weights should be checked, and these particulars entered in the Goods Inwards Book.

The invoices should be checked by the invoice clerk, with the Order Book and the Goods Inwards Book, as to particulars, quantities and weights—references to these books being placed upon the invoice. The prices should be checked with quotations, estimates, or previous invoices. After being checked thus, the invoice should be initialled by the head of the department by whom the goods or services were ordered. Having been checked, initialled

and passed, the particulars of the invoices should be entered in the Bought Day Book, and the invoices numbered and filed in the order of the entries in the Day Book.

The clerks in charge of the Bought Day Books should on no account post the entries to the Bought Ledgers, nor should they have anything to do with the drawing of the cheques in payment of accounts.

No accounts should be passed for payment until the Ledger has been posted up to date, and a responsible official should authorise the drawing of the cheques, but prior to doing so he should compare the accounts put forward for payment with the creditors' accounts in the Bought Ledger, seeing that the same agree.

The auditor should check the invoices with the Bought Day Book, unless he is satisfiedthat there is in force a very efficient internal check, in which case he should examine a proportion. As he checks each invoice, the auditor should place his audit stamp upon it, so as to prevent the same one being produced a second time. Occasionally, especially in cases of suspicion, the Order Books and Goods Inwards Books should be called for, and the Bought Day Book items tested therewith.

When examining an invoice, special attention should be paid to the following points—

(1) That the name of the creditor agrees with the entry in the Bought Day Book.

(2) That the invoice is addressed to the auditor's clients.

(3) That the date agrees with that in the Bought Day Book, and falls within the period under review.

(4) That all trade discounts have been deducted.

(5) That the net amount agrees with the Day Book entry.

(6) That the invoice has been initialled as having been checked in every way.

(7) That the item is analysed to the proper impersonal account.

(8) That from the particulars it appears to be a proper business charge.

(9) If partners' or directors' private accounts are passed through the Bought Day Book, that they are charged to their personal accounts.

(10) That any invoice charged to capital appears to be a proper capital charge, and is debited to the correct account.

Profits can be inflated easily by the suppression of invoices; therefore, at the end of the period the auditor should ask for the Goods Inwards Book and trace into the Bought Day Book all big lines of goods which have come in during the last few weeks. The invoice file for the ensuing period also may be called for, and the dates of the invoices therein examined, to see whether any of these should be charged to the period under review.

In order that the auditor may be satisfied that all invoices have been included, his clients should arrange that at the date of the Balance Sheet a notice should be sent to every creditor who has an account in the Bought Ledger, requesting him to furnish a statement showing the balance due to him at that date, or if there is nothing owing, a notification to that effect. These statements and notices should be produced to the auditor, who should compare them with the Bought Ledger accounts, seeing that such statements bear the date on which the financial period ends. If all these agree, it is proof that the individual creditors' books agree with the books of the auditor's clients, and, therefore, that, as regards these accounts, at any rate, no invoices have been omitted.

A very simple fraud may be perpetrated in connection with purchases by entering invoices twice in the Bought Day Book, in each case the creditor's account being credited. In due course and at different dates, two cheques are drawn, one being sent to the creditor and the other misappropriated. Both cheques are debited to the creditor's account, the balance upon which will agree with

the creditor's periodical statements. In order to provide a receipt in support of the second and fraudulent payment, the *bonâ fide* receipt may be produced twice unless the auditor takes the precaution of cancelling vouchers, in which case the invoice might be receipted fraudulently, or the creditor might be asked for a duplicate receipt on the pretext that the original had been lost. Such a fraud cannot be discovered unless the invoices are carefully checked with the Bought Day Book. If, however, there is a proper internal check, and the Day Book, Ledger and Cash Book are each under separate control, this fraud cannot be committed unless there be collusion.

Bought Day Book: Returns and Allowances.

In this book will be entered allowances made by the creditors of the concern whose books are under audit, in respect of goods rejected and returned, damaged goods, short weight or quantities, errors in calculation, etc. The creditor generally signifies his assent to such allowances by rendering a credit note. The auditor should see that there is a proper system for dealing with these items, and, if there is, as a rule he will be satisfied by checking the castings and postings of this book; but, of course, in cases of suspicion and exceptional items, he should compare the entries with documents, such as credit notes, Goods Outwards Books, correspondence, etc.

Sales Day Book.

The system for dealing with orders received should be investigated, and there should be Order Books in which they are entered upon receipt. The actual orders may be in the form of letters, travellers' or agents' returns, or they may be mere verbal instructions, but in all cases there should be a permanent record so arranged as to be instantly available for reference.

When the order is executed by the despatch of the goods or the completion of the work, an invoice should be

prepared and despatched immediately. The invoices should be press copied, or duplicated by means of carbon leaves, and from these copies of the actual invoices, the Sales Day Book should be written up. All goods leaving the works should be checked out by a gate-keeper, and recorded in a Goods Outwards Book.

The two main points that an auditor should guard against are the omission of sales and the inflation of the same. In the case of a small business, where the head clerk has control over the whole set of books, if he omits to enter sales, it may be possible for him to misappropriate the cash or cheques remitted in payment of such items. In these circumstances, no records of these transactions will appear in the books at all, and, consequently, this fraud could only be detected by comparing the Sales Day Book with such original records as the duplicate invoices, Order Books, Goods Outwards Books, etc. The inflation of sales will be done with the object of improperly increasing the profits or decreasing the losses, and to guard against this, also, the Sales Day Book entries should be tested with the original records, in order that the auditor may be satisfied that all the sales entered are *bonâ fide* transactions. In cases of suspicion, the Sales Day Book should be checked exhaustively, but in the ordinary way, where there is a reliable system of internal check, it will be sufficient to test a proportion of the entries. The fact that the auditor calls for the Order Books, duplicate invoices and Goods Outwards Books occasionally, creates a moral check of great value. Many auditors seem to elect to spend their time checking the Sales Day Book postings, which, it may be, have been checked already and proved by the client's staff, whereas their time would be far better occupied in testing the entries with the original records.

When checking the Sales Day Book, the auditor should be careful to see that, if any old assets have been sold and charged out through the Day Book, these amounts have

not been included in the totals credited to the sales account, but have been credited to the particular asset account.

An excellent check upon the sales which is sometimes met with in practice, is for a statement to be sent to all debtors of the concern at the date of the Balance Sheet, with a request that they will confirm the fact if the balance agrees with their books, and, if not, point out any differences. This method, when properly controlled by the management, proves to be a most valuable check upon the book debts, it acts as a check upon the sales as entered in the Sales Day Books, and is also evidence that the whole of the cash received from debtors has been accounted for in the Cash Book. In cases where fraud is suspected, one of the most effective means for detecting discrepancies is for the auditor to control the sending out of such statements, and the replies received.

Sales Day Books: Returns and Allowances.

The system as regards these credits to the Sales Ledgers should be enquired into, as it is possible that improper credits may be passed through in this way, in order to cover up misappropriations of cash received from debtors. Therefore, all credits should require the authority of a responsible official, and the credit note should be initialled and press copied, or duplicated by means of carbons. The auditor should carefully scrutinise all large credits, and, if necessary, examine the documents, such as copy credit notes, correspondence, Goods Inwards Books, etc. The credits made after the close of the year should be examined if the amounts are considerable, as sometimes, in order to make the results shown by the Profit and Loss Account more favourable, allowances, etc., are held back until after the date of the Balance Sheet.

Bills Receivable Book.

In this book will be entered all bills received, and particulars as to when the same become due, and how they are disposed of. The auditor should see that the

proceeds of every bill are accounted for, or, if a bill is dishonoured, the amount thereof is debited to the particular debtor's account in the Sales Ledger. Bills that have been met or discounted will be traced into the Cash Book and Pass Book, and those that are still current at the date of the Balance Sheet should be in hand, and should be inspected by the auditor—in this way, every bill will be accounted for. The Bill Book shows the details that make up the balance upon the Bills Receivable Account in the Ledger, and it should be seen that these are in agreement.

Bills Payable Book.

All bills accepted should be entered in this book, and as they are met they should be marked off therein. Those bills that have been paid will appear in the Cash Book, and the returned bills should be produced as vouchers. It should be seen that the balance upon the Bills Payable Account in the Ledger is in agreement with the details as shown by the Bills Payable Book.

Journal.

The Journal, of which the Bought and Sales Day Books, Bill Books, etc., are parts, should be vouched most carefully, for through the Journal will pass all extraordinary transactions for which there are no special books of first entry. The entries appearing in the Journal will be such as all opening entries; for example, the acquisition of the various assets from the vendors, the issue and allotment of shares and debentures, closing entries such as the provision for outstandings, depreciation, reserves for bad debts, interest on capital, entries correcting errors, etc., and many other miscellaneous items, such as the writing off of profits or losses upon the sale of capital assets, and various adjusting entries of this nature. From the above examples, it will be seen that these items are of a very varied nature, and that they are of great importance, as they affect the final accounts to a considerable extent. It

is, therefore, essential that the auditor should vouch thoroughly every entry passing through this book.

The actual evidence that the auditor will require will depend upon the nature of the transaction. In the case of opening entries recording the acquisition of assets under a contract, the auditor must inspect such contract, and see that the terms thereof are given effect to correctly in the entries. To vouch an allotment of shares in the case of a company, the prospectus, directors' minutes, application letters, contracts, etc., will have to be inspected. Provisions for depreciation can only be checked by discussion of the whole question with the management. In this way it may be ascertained whether or not, in the opinion of the auditor, sufficient depreciation has been written off. The adequacy of the amount reserved for bad and doubtful debts can only be verified by an inspection of the whole of the accounts contained in the Sales Ledgers.

The above are only a few examples of the entries to be found in a Journal, together with a rough idea of how some of them should be vouched. Later, these matters will be dealt with in more detail, but it will be realised at once how important it is that an auditor should exercise great care when vouching the Journal, and what a large amount of skill and experience he needs to be able to perform this part of his work efficiently.

Bought Ledgers.

The postings to the Bought Ledgers from the Cash Book, Bought Day Books, Returns and Allowances Books, Bills Payable Book, and Journal, will have been checked or tested. The castings of the Ledgers should be checked, and the balances checked on to the schedule of creditors. In the case of creditors from whom goods are purchased regularly, the auditor should see that invoices up to the end of the period have been credited to the account; if not, enquiries should be made. The best and most valuable check upon the Bought Ledger balances is the production

of creditors' statements, as these prove that the accounts are in agreement with the books of the creditors. Of course, in some cases such statements may not agree, as goods may have been debited by the creditor on or before the date of the Balance Sheet, but such goods may not have been received and credited in the books of the auditor's clients until the following period. In such cases, the auditor should carefully trace such goods through the Goods Inwards Book—confirming the dates—and he should see that these goods have not been included in stock. It may be found that certain accounts are in dispute, and, therefore, the statements disagree—in these circumstances, most careful enquiries should be made, and the correspondence should be examined to see that adequate provision is made in the accounts for all outstanding liabilities. If claims have been made by a creditor which have not been agreed to or provided for in the accounts, the auditor should insist, if the amounts involved are large, upon such claim at least being referred to in the Balance Sheet by way of a note, otherwise he should refer to the matter in his audit report. In the case of claims that are the subject of a pending lawsuit, the auditor should see that ample provision is made in the accounts for any likely liability under this head, including the legal charges. If he is not satisfied with the provision made, the matter will be one that it will be necessary for him to deal with in his report.

Any debit balances upon the Bought Ledgers should be carefully examined, with a view to ascertaining that they are *bonâ fide* amounts owing; for example, for returns, allowances, etc. If any of such debit balances are of long standing, the auditor should go into them with a responsible official, and see that adequate reserve is made for any possible bad or doubtful debts.

Sales Ledgers.

The postings, castings and balances of the Sales Ledgers should be checked in the same way as in the case of the

Bought Ledgers, but when checking the Sales Ledger balances, each account should be scrutinised with a view to ascertaining whether or not the reserve for bad and doubtful debts is a sufficient one. The auditor should ask first for a list of the bad and doubtful debts, and a certificate as to the reserve that, in the opinion of the management, is necessary to provide for the same.

When examining the Sales Ledger Accounts, the auditor should make a note of, or query upon the list of balances, all accounts that appear to him to be doubtful, and which are not included in the list of bad and doubtful debts (if any) supplied to him.

If the cash received since the close of the financial period has been posted to the ledger, the auditor will pass as good all accounts that have been paid since the date of the Balance Sheet, and he will also consider as good all debtors whose accounts are paid regularly, and who invariably take advantage of cash discounts. On the other hand, he should query all accounts where any of the following circumstances occur—

(1) Where cash payments are irregular, or where small payments are made on account.

(2) Where the balance on the account appears to be increasing, although the trade done is about the same as in the past.

(3) Where cheques or bills have been dishonoured, and, therefore, debited to the account.

(4) Where bills are constantly being renewed.

(5) Where the debt has been owing for a time considerably beyond the period of credit which is customary in the particular trade.

(6) Where notes appear upon the account, such as "Account stopped," "in solicitor's hands," "in bankruptcy," or "in liquidation," "disappeared and address unknown," etc.

All queried accounts, or such of them as do not appear upon the list of bad and doubtful debts supplied to the

auditor, should be gone into with a responsible official, and his explanations asked for. A good plan is to have the list of queried accounts ruled with columns headed (1) balance as per ledger, (2) good, (3) bad, (4) doubtful, and a further column for "remarks." As each debt is discussed with the responsible official, it should be extended into the "good," "bad," or "doubtful" column, and, if doubtful, his estimate as to the amount that probably will be received should be noted. Upon completion, the columns should be cast, and it should be seen that the reserve for bad and doubtful debts is sufficient to cover the whole of the debts estimated to be bad, and a large proportion of those estimated to be doubtful. Such proportion will be based upon the information supplied, and might be from about 40 to 50 per cent., of the total doubtful debts, but this depends upon the circumstances of the case. In addition, there should be a further provision in respect of the remaining debts that are estimated to be good, as from past experience it will be certain that a proportion will prove to be bad; probably from 1 to 5 per cent. will be a sufficient provision under this head.

Reserves for bad and doubtful debts are calculated sometimes by way of a percentage on the total book debts or upon the turnover for the period; however, this method is not recommended, and if it is adopted, the auditor should proceed as explained above, and thus satisfy himself that the reserve is a sufficient one.

The only way that a reliable opinion can be formed as to the sufficiency of a reserve for bad and doubtful debts is by examining the various debtors' accounts, and enquiring into the circumstances of all doubtful looking accounts. This is a most important part of an auditor's duties, for in many cases the total of the book debts amounts to a considerable sum, and the amount of the reserve materially affects the position shown by the accounts. The debtors represent sales that have been credited to Trading Account, but which have not been paid for, and if, in fact, part of

them are never paid for, instead of such sales representing income, they are an absolute loss ; therefore, unless the loss under this head is amply provided for, the profits will be over-stated, as also will be the book debts. The difficulty is that this loss has to be estimated, and it is, therefore, of the utmost importance that every precaution should be taken to arrive at as accurate an estimate as possible, and this can only be done by adopting some such method as is described above.

If, after completing his investigation under this head, the auditor is of opinion that the reserve is not sufficient, he should put his views before the directors or partners, as the case may be, and hear what they have to say upon the point. If, thereafter, he is still of the same opinion, and, nevertheless, the directors or partners refuse to alter the accounts, he should then point out in his audit report that, in his view, the reserve is inadequate.

CHAPTER IV

THE PROFIT AND LOSS ACCOUNT AND BALANCE SHEET

Impersonal Ledger.

HAVING checked the Sales and Bought Ledgers, the auditor must turn his attention to the Impersonal or General Ledger, the exhaustive checking of which is of the utmost importance. The detail postings from the Cash Book and Journal, and the totals from the Day Books, Bill Books, etc., will have been checked, and now the castings of each account should be verified, and the balances checked on to the Trial Balance. Each account should be examined carefully, in order that the auditor may satisfy himself that he has checked sufficiently the details making up the balance, and that such items are in order, properly classified, and described in the particular account. On no account should this part of the work be carried out mechanically, but keen intelligence must be exercised, as the Impersonal Ledger contains most of the material from which the Profit and Loss Account and Balance Sheet are built up, and it is the auditor's duty to see that these are properly drawn up, so as to exhibit a true and correct view of the state of the affairs of the concern; and whether this is so or not largely depends upon how accurately and correctly the Impersonal Ledger has been kept. An auditor should bear in mind, when engaged upon the detail checking of an audit, that every item directly or indirectly affects the final accounts, and, therefore, he must see that the details are recorded and classified correctly, and in such a way that they will find their correct place in either the Profit and Loss Account or the Balance Sheet. Every account in the Impersonal Ledger should be, as it were, alive to him, and the exact nature of all the detail

items making up the balance should be appreciated and understood.

Grouping Items in Accounts.

The Profit and Loss Account and Balance Sheet are summaries, that is to say, most of the individual items included therein are composed of a number of separate amounts, and it is the duty of the auditor to examine such details and to see that the summarising and grouping of the items is done correctly. He must see that only transactions and items of a like nature are grouped together, that is, that the heading given fairly describes every component item; otherwise, by incorrect classification, the results shown by the accounts may be made to be absolutely misleading. For example, this will be the case if revenue charges such as repairs to plant are debited to Plant and Machinery Account, or if, in framing the Balance Sheet, debit balances upon such accounts as Preliminary Expenses, Advertising Suspense, Payments in Advance, and, to take an extreme case, Profit and Loss Account, are included under the heading " Sundry Debtors." For the term " Sundry Debtors " should cover only amounts owing and payable to the concern, such as trade book debts contained in the Sales Ledgers, whereas the items above do not represent moneys owing at all, and are not assets in the ordinary sense, but represent moneys spent, resulting in debit balances, which, as a matter of accountancy, must be carried forward in the Balance Sheet until they are written off to Profit and Loss Account. Such items, therefore, should not be included with liquid assets, but should be stated separately and described clearly, so that the exact position of affairs may be appreciated.

The exact form of the final accounts, the headings under which the transactions should be classified, and the order in which the items should appear in the Profit and Loss Account and Balance Sheet, are all matters of personal opinion, and in respect of which opinions differ. The

auditor is not concerned with these questions, provided that the position shown by the accounts is a clear and true reflection of the state of affairs. He must see that only items of a like nature are grouped together, that there is sufficient sub-division to make the accounts clear and intelligible, and that there is no suppression of material facts.

The final accounts are mere summaries built up from, it may be, thousands of detail items, and such accounts merely give an indication as to the financial state of affairs, and disclose the combined effect of all the business transactions that have been carried out during the period of the accounts—only by going behind the accounts and examining the details can the nature and result of the various transactions be appreciated, and the accuracy of the summaries be verified. It is for this purpose, therefore, that the auditor is appointed, namely, that he may examine into all such detail, and thus satisfy himself whether or not all the transactions are in order, and that the accounts are correct summaries, giving a fair indication of the results of the trading for the period, and the financial position at the date of the Balance Sheet.

The Principles Governing the Preparation of Trading, Profit and Loss, and Appropriation Accounts.

Auditors have to criticise the form in which accounts are drawn up ; further, they often are requested to prepare the accounts, or to give advice in this connection, and, therefore, although this subject belongs more to accountancy than auditing, it is thought that it will not be out of place to consider briefly some of the principles governing the preparation of the Profit and Loss Account and Balance Sheet, before passing to the detailed work connected with the audit thereof. For it is essential that, before criticising, an auditor must have a correct knowledge as to how such accounts should be drawn up, in order that all necessary

information may be disclosed in a form that will be easily understood. Accountants are apt to forget that their accounts are not prepared for accountants, but for the information of the general public, and that, therefore, accounts should be made as simple as possible.

The Profit and Loss Account of a merchant or manufacturer is generally divided into three sections, viz., the Trading or Manufacturing Account, the Profit and Loss Account, and the Appropriation Account. In the case of non-trading concerns such as hospitals, clubs, private individuals, etc., the corresponding account is called generally the Income and Expenditure Account, but the object is the same, namely, to group the results of the various revenue transactions entered into during a given period, so that the final profit or loss may be ascertained. The exact form of an Income and Expenditure Account depends upon the nature of the transactions carried out; but the account should be so drawn up as to disclose the amounts received from the various sources of income, and the various expenses and losses incurred in earning or obtaining the same. Some companies use the term Revenue Account instead of Profit and Loss Account.

TRADING ACCOUNT. In the case of a merchant or trader, the object of this account is to show the difference between the total amount for which the goods have been sold during the period, and the total purchase price of such goods. This difference is called the "gross profit or loss," and, therefore, represents the difference between the buying and selling prices.

In the case of a manufacturer, the Trading Account will be debited with the cost of the raw materials, including the carriage thereon, and the manufacturing wages expended in order to convert such materials into the finished articles that are sold. The Trading Account should be debited only with the direct costs of production, and the items included should be such as vary directly with the turnover.

The opening and closing stocks will have to be brought

into the Trading Account, for against the sales of the period that are credited must be charged only the cost of the goods sold, but, probably, part of the goods sold will have been purchased in previous periods, and a proportion of the goods purchased during the period, and included in the purchases, will not have been sold. Therefore, in order to adjust this, stock must be taken at the close of each financial period, and thus the Trading Account is debited with the opening stock at cost price, that is, with the cost of goods purchased during previous periods but sold during the period under review, and credited with the closing stock, that is, with the goods purchased during the current period but not sold, and which must, therefore, be charged on to the next period during which, in the ordinary course, the same will be sold.

One of the chief objects of the preparation of the Trading Account is to ascertain the percentage that the gross profit bears to the sales, as this information is of considerable commercial value to the proprietors of the business. The variations in this percentage as between one period and another should be watched carefully by the auditor, and if the rise or fall is considerable, he should enquire most strictly as to the reasons.

Profit and Loss Account. The balance upon the Trading Account is carried to the Profit and Loss Account, which latter account is credited with any miscellaneous income, other than that from sales, such as rents, interest, discounts, etc., received. It should be debited with every expense, loss, or charge of the business for the period, other than those in the Trading Account, and the balance thus obtained is the net profit or loss upon the whole of the business transactions for such period.

Appropriation Account. The net profit or loss is carried to the Appropriation Account, which account, in the case of a partnership, shows the division of such profit or loss between the partners in accordance with the terms of the partnership. In the case of a company, the Appropriation

Account includes the net profit or loss for the period, the balance brought forward from the last period, and any transfers to general reserve and dividends paid, the final balance representing the amount available for distribution amongst the shareholders, or the final deficit, as the case may be.

Adjustment of Nominal Accounts.

The Trading, Profit and Loss, and Appropriation Accounts are built up from the nominal accounts contained in the Impersonal Ledger, all such nominal accounts being closed by the transfer of the balances thereon to the three former accounts. All nominal accounts must be checked carefully by the auditor, so that he may be satisfied that all the transactions of the business have been correctly classified and included in the final accounts. In this connection, he must see that all outstanding expenses, charges and losses have been brought into the period under review, and that payments in advance and sundry amounts due have been properly adjusted and brought into account. The following are examples of various outstanding liabilities,—other than Bought Ledger accounts which have been dealt with already,—and the methods that an auditor should adopt with regard to each.

Provision for Outstanding Liabilities, etc.

Rent, Rates, Taxes, Gas, Electricity and Water, Etc. The auditor should inspect ledger accounts, demand notes, and receipts, carefully noting the period covered by each payment and seeing that any accrued and unpaid proportion to the date of the Balance Sheet is provided for. He should also compare the amount debited to such account with those included in the corresponding nominal account for the previous year, to see that all the rents, rates and taxes, etc., payable have been included.

Wages. The date up to which the wages have been paid should be ascertained, and if there are any days

between that date and the close of the financial year, a corresponding proportion of the ensuing week's wages should be calculated and provided for.

Salaries. The auditor should inspect the Salaries Account and Salaries Book, and note the dates up to which salaries have been paid, and see that provision is made for any outstanding amounts.

Travellers' Commissions and Expenses. The auditor should inspect the Commission Books of the various travellers, and see that any commissions earned to the end of the financial period but unpaid at that date, are provided for; ascertain the arrangements as regards expenses, and see that any outstandings are brought into account.

Legal Charges. Enquiries should be made as to whether there are any amounts owing under this head; if so the auditor should call for the solicitors' bills of costs and see that these amounts are included in the accounts.

Audit Fee. The fee for the period covered by the accounts should be provided for.

Interest Payable. If there are any loans, mortgages, debentures, etc., it is necessary to see that the interest accrued to the date of the Balance Sheet is provided for.

Sundry Expenses. All the other nominal accounts should be inspected to see that all the various expenses and charges for the period have been included—these will consist, for example, of repairs, fuel, freight, carriage, dock dues, subscriptions, advertising, and many other items of expense. The auditor may be able to trace outstanding amounts by an examination of the receipts and invoices of the amounts debited during the period, noting the dates up to which such invoices run, and making enquiries where such dates fall short of the end of the financial period. He may also inspect order books, and an examination of the Cash Book entries and invoice files for the succeeding period often discloses items for which no provision has been made. In some cases, where accounts have not been received, the amounts will have to be estimated.

Payments in Advance. Under this head will be included rents, rates, taxes, insurances, subscriptions, etc., paid for periods that extend beyond the end of the financial year of the particular concern. The auditor should examine the nominal accounts and the demand notes and receipts, seeing that a correct calculation has been made of the proportion unexpired at the date of the Balance Sheet.

Sundry Amounts Receivable. There may be various amounts due to the concern, and for which credit should be taken in the accounts, such as rents, interest on loans, dividends, royalties, commissions, etc., accrued due but not yet received. The nominal accounts should be inspected and any available evidence called for to substantiate the amounts that have been provided for as owing, reserve being made for any amounts the receipt of which is doubtful.

All these outstandings may be entered in an Outstandings Book, or in the Journal, and the amounts provided should be compared with those of the previous periods, as this may draw attention to any which have been overlooked.

The proper provision for outstandings directly affects the Profit and Loss Account, for in this way each nominal account is made to include the exact income or charge applicable to the period of the accounts. There is bound to be a certain amount of overlapping of transactions as between one period and another, but, in order to prepare accurate and exact accounts, it is necessary to draw a line at the date upon which the period closes, and, therefore, all these adjustments have to be made.

The Principles Governing the Preparation of the Balance Sheet.

The Balance Sheet is the all-important document with which an auditor has to deal, and it is the one, in the case of a company, to which he has to attach his report, or to which his report must refer. There is a considerable amount of misunderstanding in the commercial world as

to what exactly a Balance Sheet is, and what it purports to show; it is, therefore, of the utmost importance that every auditor should understand the true meaning and purpose of a Balance Sheet.

DEFINITION OF BALANCE SHEET. A Balance Sheet is *not* a statement of assets and liabilities, as is commonly thought, but merely a "sheet" showing a classified summary of all the balances appearing in a set of books, after all the nominal accounts have been closed by transfer to the Profit and Loss Account—the Balance Sheet including the balance on the latter account. The Balance Sheet, therefore, is not an actual account in the books, as is the Profit and Loss Account, but merely shows, in classified form, the whole of the balances open after the nominal accounts have been closed. It will include all the assets and liabilities of the business, but in many cases it includes items on both sides which are neither the one nor the other. For example: if there is a debit balance on the Profit and Loss Account, this balance, in the case of a company, must appear on the right-hand side of the Balance Sheet, but this balance cannot be termed "an asset." Again, when expenditure, such as preliminary expenses, discount upon an issue of debentures, advertising, alterations, etc., is being written off to Profit and Loss Account over a period of years, the balance carried forward must appear in the Balance Sheet. On the other hand, such items as reserve funds, amounts paid on shares forfeited, and a credit balance on Profit and Loss Account, must appear upon the left-hand side of the Balance Sheet, but are not what are commonly understood by the term "liabilities."

For the foregoing reasons, therefore, a Balance Sheet should not have the sides headed "liabilities" and "assets," for if the right-hand side is headed "assets" it must mean that every item underneath is an asset, and that the total at the foot represents the total value of the assets of the concern, whereas, as explained above, often this is not the

case. It is very common, even in the accountancy profession, to head the sides of the Balance Sheet in this way—with the result that the general public have formed quite erroneous ideas as to what a Balance Sheet is, looking upon it as simply and purely a statement of assets and liabilities. The form in which the Balance Sheet has been presented to them is largely responsible for this, and, in fact, justifies this false impression. These headings have been handed down from the past, and if those who use them were to ask themselves seriously why they have adopted them and exactly what they mean and imply, probably they would see strong reasons for discontinuing the practice.

A Balance Sheet should have no headings to the two sides, and, as it is not an account, the signs "Dr." and "Cr." should not appear, nor should the terms "To" and "By" be used, for, as its name implies, it is merely a sheet of balances.

If properly prepared, a Balance Sheet should show a true and correct view of the state of the affairs of the concern, and in particular will show exactly the nature of all the assets and liabilities, but it will often include other items as well, and, therefore, these latter should be clearly described so that the whole position may be perfectly clear. An auditor's duty is to satisfy himself that the Balance Sheet is properly drawn up upon the foregoing principles, and to report accordingly to those employing him.

MAIN OBJECT OF BALANCE SHEET. The main object with which a Balance Sheet is drawn up is to ascertain the profit or loss of the concern during a given period, though, in addition, it is of great value in showing the financial position at date, and whether the capital is intact or not, and how such capital is invested. The capital represents the excess of assets over liabilities, though for this purpose, debit balances carried forward upon such accounts as preliminary expenses, advertising suspense, etc., are

included with the assets. If, therefore, the surplus of assets over liabilities has increased during a given period, this must mean that a profit has been made since the date of the last Balance Sheet ; on the other hand, should the surplus be less, a loss must have been incurred. But, in comparing the opening and closing capital, for this purpose, it must be seen whether any further capital has been paid into the business, or whether there have been any withdrawals during the period. If so, in order to arrive at the profit or loss, the additions must be deducted from, and the withdrawals added to, the closing capital, the resulting figure being compared with the opening capital and disclosing the profit or loss. A profit may be said to be an increase, and a loss a decrease in the capital invested in a business. A Profit and Loss Account merely amplifies the information disclosed by the Balance Sheet, the former showing exactly how such profit or loss has arisen.

As the capital represents the surplus of assets over liabilities, and as the increase or decrease of such surplus represents the profit or loss, it will be seen that the ascertainment of the profit or loss is absolutely dependent upon the valuation of the assets. It is possible, as a rule, to ascertain the amount of the liabilities exactly, except in the case of contingent liabilities, such as claims which are the subject of dispute, in which case the total liability under this head will have to be estimated ; but, on the other hand, though the assets belonging to a business can easily be ascertained, it is practically impossible in many cases to fix their exact value until such assets are sold. But the fixed assets, that is, the assets by the use of which the business is carried on, such as land and buildings, plant and machinery, mines, concessions, etc., are not held with a view to re-sale, and, in fact, may never be sold unless and until the business is finally wound up. Consequently, in the meantime, the valuation of such assets is a matter of estimate and personal opinion. Even if expert valuers

were employed, probably no two valuers would arrive at the same result—for instance, in the case of a factory equipped with machinery being valued by two independent expert valuers, the respective total valuations might differ by thousands of pounds. In a lesser degree, the same applies to the valuation of stock-in-trade, book debts, and other such assets which are held with a view to more or less immediate conversion into cash. And, though it is necessary to estimate their value, it is impossible to guarantee that such valuations will prove to be exact.

VALUATION OF ASSETS. Another question to be considered in connection with the valuation of assets for Balance Sheet purposes is, whether the valuation should be based upon market or exchangeable values, that is, the amount that it is estimated such assets would realise if sold, or upon the value of such assets to the business as a going concern, that is, their value to the proprietor for the purpose for which he requires them. As will be seen alter, both these methods are adopted when valuing assets for inclusion in a Balance Sheet.

Again, there can be no true profit unless the original capital, together with any additions thereto, is intact; therefore, if any of the assets in which part of such capital is invested are of a wasting nature, or are consumed in the course of earning revenue, such wastage must be made good before the true profit can be arrived at. But it is impossible to state precisely what, for example, will be the working life of plant and machinery, or what is the total quantity of ore in a mine, and how long it will take to extract such ore.

For the above reasons, it will be seen that it is impossible to arrive at the profits or losses of a continuing business exactly, and actual true profit is seldom ascertained. The results are absolutely dependent upon the valuation of the assets of the business, and it is impossible to fix such values with absolute precision. These facts must be realised and appreciated by accountants, who should make

these root principles clear to their clients, whom they must not lead into the belief that absolute exactitude and certainty can be achieved in the periodical accounts of their businesses.

For commercial purposes, the assets are valued according to certain conventional rules, and the profit or loss arrived at in this way is considered sufficiently near and accurate for ordinary business purposes, and, by means of conservative estimates and reserves, well conducted concerns leave a margin to provide against errors in valuation, and for unforeseen contingencies.

For Balance Sheet purposes, the assets of a business are divided under two headings *i.e.*, "Fixed Assets" and "Floating Assets."

Fixed and Floating Assets. Fixed Assets are those assets of a permanent nature which are acquired by an undertaking with a view to earning profits for a period of years by the use of the same, and such assets are not held for the purpose of re-sale. For example, the plant and machinery of a factory is held with a view to manufacturing with the same for the whole period of the working life of such plant.

Floating assets are those assets which are produced or acquired by an undertaking in the course of or for the purpose of its trading, and consist of cash and such assets as are held with a view to conversion into cash as soon as possible. Examples of floating assets are: stock-in-trade, work in progress, and book debts; and it will be seen that these assets are those *in which* a trader trades, and their various stages of conversion into cash, as opposed to fixed assets, which are those *with which* he trades, and which are not held with a view to conversion into cash.

Fixed assets are valued upon the basis of cost, and if such assets are of a wasting nature, the original cost price in most cases is written off to revenue, by means of depreciation over the period of the estimated working life of

such asset. At any intermediate date, therefore, the fixed assets will appear in the Balance Sheet at cost, less the depreciation (if any) written off to date, and this represents the present value of such assets to the particular undertaking as a going concern, or, in other words, the value of such assets to the proprietors of the particular business. Current market value and break-up value are disregarded, as these do not affect the working lives of the particular assets at all. "Market value" represents the amount that an asset would produce if sold in the open market, and "break-up value" is the amount that would be realised by a forced sale under the hammer, in the case where the business is closed down. Fixed assets are not valued upon their saleable value, but upon their value to the proprietor of the business—in other words, upon their ability to earn profits, and not upon their intrinsic value. It will be seen, therefore, that such Balance Sheet values are more or less hypothetical, and that there is a likelihood of error, for it is impossible to fix, with absolute certainty, the period of the working life of a fixed asset. If errors are made, the profit or loss will be affected immediately. On the other hand, the fluctuation in market value of a fixed asset does not affect the proprietor, except at the end of the asset's life, when it may have to be replaced, in which case the price of the new asset may be more or less than the cost of the original one. But, apart from this, such fluctuations are immaterial, for they do not add to or reduce by a day the period during which such assets will earn profits, and provided the original cost has been written off during this period, the results shown by the accounts have been, for practical purposes, absolutely accurate.

Floating assets should be valued upon the basis of either cost or market price, according to which is the lower at the date of the Balance Sheet—the reason being that, since these assets are held with a view to re-sale, if the market price has dropped, and such fall is not a mere

fluctuation, but appears to represent a more or less permanent fall, then in effect a loss has been made on the purchase, and should, therefore, be provided for. For if, owing to the high prices at which the goods were purchased, and to the subsequent fall in market prices, it appears that probably it will be impossible to sell the goods in the ensuing year at a profit, then the loss should be provided for at once, and should fall upon the year in which the goods were purchased.

On no account should floating assets be valued above cost price, as the effect would be to take into account a purely fictitious and unrealised profit. For if certain goods are purchased for £500, and remain unsold at the date of the Balance Sheet, when the market value of the same is £600, it cannot be said that a profit of £100 has been made, but merely that if these prices are maintained it appears likely that, upon realisation, such a profit may be made. Again, if such goods were valued at £600, apart from other transactions, the accounts would show a profit of £100 available for the proprietors of the business, but, in fact, there would not be a penny piece representing such supposed profit, which, therefore, would be a mere paper one.

The foregoing reasoning might be used to argue against the necessity of writing down the value of floating assets in cases where the market values are below cost. But accounts should be prepared upon the basis that losses should be anticipated, but profits never, for if provision is made for an estimated loss, and it subsequently transpires that this estimate was incorrect, and that, in fact, the transaction resulted in a profit, no harm will have been done, and the succeeding year will benefit to the extent that the previous year's profits were under-estimated. But, on the other hand, if a profit is anticipated and taken credit for before the same is realised, then such estimated profit may have been paid away to the proprietors of the business, and upon it being found subsequently that this

profit was unjustified, the transaction having resulted in a loss, it may be impossible to recover from the proprietors this over-payment, and, consequently, the capital of the business will be reduced to the extent of this over-estimation of profit in the past.

Auditor's Position as Regards the Valuation of Assets.

From the foregoing, it will be seen how dependent the Profit and Loss Account and Balance Sheet are upon the valuation of the various assets of a concern, but it must be observed that an auditor cannot possibly value the assets of all the businesses whose accounts he audits. This valuation must be carried out by the partners, directors, or other responsible officials ; all that an auditor can do is to ascertain as far as possible that such valuations appear to be fair and reasonable, that they are based upon correct principles, and that all contingencies appear to have been provided for. In the case of some assets, such as investments in securities of which there are market quotations, the auditor can check the valuations exactly, but in the case of others, such as land, buildings, plant and machinery, there is no means by which he can determine the precise value. The steps that an auditor should take, in order to satisfy himself that the valuations appear to be fair and reasonable, will be discussed in the course of the following chapters, but, before proceeding further, the limitations of a Balance Sheet and the limitations of an audit, especially with regard to the valuation of assets, should be clearly understood and appreciated ; accountants should not claim for an audited Balance Sheet absolute exactitude, but merely that it shows the fairest possible estimate of the position of affairs, arrived at in accordance with the accepted rules, and checked and tested in every reasonable manner. On no account should the impression be given that an audit guarantees that the position shown is correct in every detail, for the future may show that

the most carefully prepared and audited Balance Sheet has considerably mis-stated the real position of affairs. Great harm only can be done to the profession if accountants assume for an audited Balance Sheet virtues that it does not and cannot possibly possess.

CHAPTER V

VALUATION AND VERIFICATION OF ASSETS

In the preceding chapter it has been pointed out that the values of the assets of a business for Balance Sheet purposes have to be *estimated*, that such valuations are bound to be more or less approximate, and that they are not in all cases based upon the market values, but upon certain accepted rules. On the other hand, it must be recognised that the Balance Sheet is absolutely dependent upon the valuation of the assets, and that, therefore, this matter must be gone into with the utmost care, so that the results shown may be sufficiently accurate for all practical purposes. It is now proposed to deal with the valuation of various common assets which are constantly met with in practice, and to explain the auditor's duties with regard thereto. But it must be borne in mind that the actual valuations are made by the proprietors or officials of the concern, who have a practical knowledge of such assets, and that an auditor's duty is confined to testing the valuations as far as he can, and in this way satisfying himself that the position shown appears to be correct; he cannot, however, in any way guarantee the accuracy of the Balance Sheet.

At the same time, the auditor's duties as regards the verification of assets will also be discussed. The assets of a business will be ascertained from the books of account, and it is the auditor's duty to see that all those thus disclosed are properly and clearly set out in the Balance Sheet, and appear to be correctly valued. But this is not sufficient, for, having found from the books what assets ought to be in the possession of the concern, he must then satisfy himself that such assets were actually in its possession at the date of the Balance Sheet, and that the same were free from all charges except those disclosed in the

books. This is a most important part of an auditor's duties, for, although he may have vouched the original payment upon the purchase, that is no evidence at all that that asset was still in the possession of the concern at a subsequent date. The auditor, therefore, should attend at the close of the period for the purpose of verifying the assets as at that date. This entails the inspection of such evidence as will satisfy the auditor that such assets are actually in the possession of his clients.

When examining securities for this purpose, care and method must be adopted to prevent substitution; that is to say, that when, for example, there are two or more securities of a like nature, one batch of securities is not produced to verify both investments. If considerable care is not exercised, this fraud is extremely simple. For instance, suppose the case of a company holding as an investment certain debenture bonds, having in all one hundred £50 bearer bonds; unless all these bonds are produced at the same time, the verification will be useless—for if the auditor had one batch of fifty produced to him by the manager, who thereafter took these away, and then produced another batch of fifty, it would be impossible, unless the auditor noted all the numbers upon the bonds produced, to ensure that the same bonds were not produced twice. In fact, this particular form of fraud in the past has been perpetrated for years in succession, covering up serious defalcations. Therefore, when examining securities, such as the title deeds of freehold and leasehold property, share certificates, bonds, bills, etc., the auditor must see that the whole of the securities are produced to him at one time, and that all remain under his entire control during the whole of the time of his examination. A simple way of doing this is to have all the keys of the strong room and safes, where the securities are kept, handed to the auditor at the commencement, and these he should retain in his possession until he has completed his examination of the securities.

Further, he should conduct the whole of the examination himself, assisted by his own staff, and as little as possible by the staff of his clients.

Cash in Hand. The auditor should attend at the close of business upon the date of the Balance Sheet, or on the following morning, and count all cash balances in hand, comparing the same with the balances according to the books. If there are two or more cash balances, such as petty cash, cash in till, etc., the whole of the cash should be produced at one and the same time, in order to prevent shortages upon one account being made up out of the cash belonging to another.

If the auditor cannot attend immediately upon the close of the financial period for the purpose of counting the cash, he should, when he subsequently attends, check and vouch the petty cash, till books, etc., up to date, and then count the cash, comparing the same with the balances shown by the books.

A very good plan is to arrange that all cash balances at the close of each financial period shall be paid into the bank upon the last day of such period, cheques being drawn upon the following day to re-open the cash accounts. In this way all cash balances are automatically counted and accounted for, and the auditor is thus saved from a somewhat invidious task.

Unless absolutely necessary, large cash balances should not be allowed, and if cash balances show a tendency to increase, the auditor should make careful enquiries as to the necessity for them and their actual existence, and bring the facts to the notice of the principals of the business.

Bank Balances. The Cash Book should be checked with the Pass Book as previously described, and the two balances agreed by means of the reconciliation statement. Thereafter, a certificate should be obtained by the auditor direct from the bankers, as to the balance according to their books at the close of business upon the date of the Balance Sheet, it being seen that this balance agrees with

the balance according to the Pass Book produced. Any balance upon "Deposit Account" should be verified in the same way.

Investments. When possible, the best way to deal with investments is to have a separate account opened in the Ledger for each investment, the amount debited being the actual cost. If shares or debentures have been issued to the concern as consideration for services rendered, then whatever outlay has been incurred in connection with such services, should be debited to the particular investment account, as representing the actual cost of the shares or debentures received. If, however, there are no such expenses or outlay, an account should be opened for such shares or debentures, but no amount should be placed in the cost column. In this way every investment appears in the books at the actual bare cost, and remains at this figure until sold when the amount realised will be credited to the particular account, and the profit or loss upon realisation will be ascertained thus and written off.

At the date of each Balance Sheet, a schedule should be prepared and presented to the auditor, giving particulars of each investment, the cost thereof according to the Ledger, and a fair valuation at date, based upon current market prices. For the purpose of this valuation, temporary market fluctuations may be disregarded; for example, if upon the date of a Balance Sheet all markets were abnormally depressed owing to a war scare, which, by the time the audit is being completed, has subsided and the markets have righted themselves, it would not be necessary to value upon the basis of such abnormal prices, but a fair average price should be taken. But, except in exceptional circumstances such as the above, each investment should be included on the list at the market price.

In the case of holdings in companies whose shares are not quoted, the Balance Sheets of such companies should be inspected, and a fair value placed upon such shares

based upon the position thus disclosed, and any other information that can be obtained.

The two columns, that is, the cost and the market value, should be added, and if the total of the re-valuation equals or exceeds the total cost, then the investments as a whole should appear in the Balance Sheet at cost, but if the total of the re-valuation is less than the cost price, a reserve should be made to provide for this estimated shrinkage in value. Any such provision should be debited to the Profit and Loss Account, and shown in the Balance Sheet as a deduction from the total cost of the investments. The question whether, in the case of a company, it is legally necessary to provide for such a depreciation in value, will be considered in Chapter IX, but there can be no question that this is a very wise course to adopt, though it must not be thought that investments must invariably be written down to the market value at the date of the Balance Sheet; for in some cases investments may be held for many years, during which time the market values may fluctuate between very wide margins, but, until they are finally sold, no actual profit or loss arises. The best method is to deal with the investments as a whole, and to make a reserve to cover any likely losses upon realisation. In some cases the investments are shown in the Balance Sheet at cost, with a note against the item as to the market value at date.

In all cases the basis of the valuation should be stated upon the Balance Sheet, that is, as to whether the valuation is "at cost," "market prices," or "at cost less a reserve," and, further, the investments should be sub-divided in the Balance Sheet in such a way that a fair idea is given as to their nature—that is to say, there should not be one item "investments" in the Balance Sheet, which includes investments of widely different classes, as, for example, Consols and holdings in small private companies, but if a detailed list of the investments is not given, holdings of a like nature only should be grouped together, and these

should be adequately described, so that the Balance Sheet may show what proportion of capital is invested in what are commonly called "gilt edged" securities, and what amount in speculative investments, in connection with which the risk of loss is very much greater.

So far as the auditor is concerned, he should check the list with the Ledger, and check the valuations, seeing that an adequate reserve is provided against possible losses upon realisation. If no such reserve is made, he should see that a note as to the market value appears upon the Balance Sheet, or that the investments are distinctly stated as being "at cost," and, if the fall in value be very heavy, he may consider it necessary to refer to the matter in his audit report. On no account should investments appear in the Balance Sheet at a value above cost, such estimated increase being credited to Profit and Loss Account, as if this is done credit will be taken for what is but an estimated and "paper" profit, such supposed profit not being represented by a penny piece with which, in the case of a company, a dividend could be paid.

As regards the verification of investments, the procedure will be as follows—

INSCRIBED STOCKS. An application must be sent to the banker or agent's office where the stock is inscribed, such application being made upon official forms, which must be signed by one of the stock-holders; details must be given as to the nature of the stock, the amount held, the names in which it is held, the date at which it is to be certified, and to whom the certified form is to be sent, who, for this purpose, should be the auditor. The form must also be accompanied by the prescribed fee for verification. The banker or agent then compares the particulars with the records in his books, and if found to agree, certifies the form as correct, and returns it as directed. For audit purposes, application will have to be made in the same way each year. When inscribed stocks are bought, the purchaser is given a certificate by the banker or agent

that the same have been duly inscribed, but as this certificate has not to be produced when the stock is sold, it is of no value to an auditor, and on no account should it be accepted as a verification of such holding at a subsequent date. The following are a few examples of inscribed stocks that will have to be verified in this manner: Consols, annuities, London County Council stocks, local loans, India 3 per cent. and $3\frac{1}{2}$ per cent. stocks, various Municipal and Colonial stocks.

DEBENTURES AND REGISTERED SHARES IN COMPANIES. The debentures or share certificates must be inspected, it being noted that they are made out in the names of the auditor's clients or their nominees—in the latter case, a certificate should be obtained from the nominees that they hold for the auditor's clients, and that they have no charge upon such investments.

In the case of new issues, in respect of which debentures or certificates have not yet been issued to the holders, the auditor will require to see the allotment letters and the bankers' receipts for the instalments that have been paid.

DEBENTURE BONDS AND SHARE WARRANTS TO BEARER. The bonds or warrants should be inspected, it being seen that all unpaid interest or dividend coupons are attached.

Book Debts. The auditor's duties as regards this asset have been dealt with already in connection with the audit of the Sales Ledgers, his object being to satisfy himself that the amounts shown as owing appear to be *bonâ fide* debts, and that a sufficient reserve is provided for bad and doubtful debts. If in the case of a company, the book debts include amounts owing by directors or managers for goods or loans, unless the amounts involved are very small and appear from the Ledgers to be always promptly and regularly settled, the auditor should insist upon such debts being shown separately upon the Balance Sheet, and if the directors refuse to disclose these amounts, he should draw attention thereto in his audit report.

Bills Receivable. A schedule of the bills in hand at

the date of the Balance Sheet should be produced to the auditor, and he should compare the same with the Bills Receivable Book, and see that the total of the list agrees with the balance upon the Bills Receivable Account in the Ledger. He should then examine all the bills actually in hand, noting that they appear to be properly made out, completed and stamped, and that they are not overdue. If certain of the bills are in the hands of the clients' bankers for collection, the bank should be requested to supply the auditor with a certified list of such bills. If the audit is not completed until some time after the date of the Balance Sheet, a proportion of the bills probably will have matured, and the cash for these should be traced into the Cash Book and Pass Book, and any that have been dishonoured or renewed will thus be discovered, in which case careful enquiry should be made as to the reserve necessary to provide against possible bad debts. With regard to the balance of the bills that are still current at the time of the audit, the auditor should go through the list of these with a responsible official, and enquire as to the sufficiency of the reserve (if any) that has been provided under this head. The total amount of the bills receivable is, in many cases, considerable, and, therefore, the auditor must satisfy himself that the same is a good asset, and that an adequate reserve has been provided for possible losses through bad debts.

If any bills are under discount at the date of the Balance Sheet, the auditor should require a list of such bills, and he should compare this list with the entries in the Bills Receivable Book. The total amount of the bills under discount should appear as a contingent liability, being shown by way of a note upon the Balance Sheet. Enquiry should be made as to whether any of the bills that have become due since the date of the Balance Sheet have been dishonoured, and as to the reserve necessary to provide for any anticipated bad debts.

Stock-in-Trade. Stock-in-trade is a floating asset that

is held with a view to more or less immediate re-sale; therefore, the general rule is that the basis of valuation should be cost or market price, according to which is the lower at the date of the Balance Sheet, and on no account should stock be valued above cost, as if so, a profit is anticipated which has not been and may never be realised. The object of taking stock is to credit to the period under review, and charge on to the succeeding period, the materials and goods unused or unsold, which will be used or sold in the latter period; therefore, the correct basis for valuation is, cost or under—there can be no question of a profit until such stock is actually sold.

In the case of a merchant, whose business consists of buying goods and selling them in the same state as that in which they are purchased, the valuation should be either cost or market price, whichever is the lower, for if the market price has dropped, and such fall is not a mere fluctuation, but represents a more or less permanent fall, then in effect a loss has been made on the purchase, and should, therefore, be provided for. For if, owing to the high price at which the goods were purchased, and to the subsequent fall in market prices, it appears likely that it will be impossible to sell the goods in the ensuing period at a profit, then the loss should be provided for at once, and should fall upon the year in which the goods were purchased. Stock-in-trade should be charged on to the succeeding period at a price that will give that period a fair chance of selling at a profit.

The stock-in-trade of a manufacturer will include raw materials and goods partly made and finished. As regards raw materials, the basis of valuation should be cost plus direct charges, such as the freight, carriage, etc., of such goods to the factory, and the cost price figure should be the invoice prices, less all trade discounts and allowances. The market prices are, in certain cases, disregarded when dealing with raw materials for manufacture, as, for instance, in the case of hops in a brewery. Here, the hops are not

purchased with a view to re-sale as hops, but for the purpose of brewing beer. The position, therefore, is, that these hops have been purchased in one year, but will not be used until the following year; therefore, in order to ascertain the true profit or loss upon the next year's brew, that account must be charged with the actual cost of the materials used, whether the same were purchased in the previous year or not. Therefore, these hops should be taken into stock at cost—for, supposing that after the brewery had purchased its hops the market price of hops fell, it would mean, *not* that the brewery have made a loss, but that *if* they had waited and purchased at the subsequent lower prices, they would have made a larger profit out of the next year's brew, which is quite another matter; therefore, the next year must be charged with the actual cost of the materials consumed, so that that year's Brewing Account may show the actual gross profit or loss thereon.

Raw materials are not held with a view to re-sale in their original form, but are held for the purpose of manufacture, and, therefore, in ordinary cases the cost price is a fair basis of valuation for stocktaking purposes. But if there has been a heavy fall in the market price of raw materials, which has resulted or will result in a fall in the prices obtainable for the manufactured goods, then the raw materials should be written down, so that the probable loss, owing to the bad buying, is anticipated, and the materials are charged on to the ensuing year at a price that will enable that year to manufacture at a fair profit.

In the case of unfinished and completely manufactured goods, the basis of valuation should be the cost of the raw materials, and direct manufacturing labour consumed on them to the date of the Balance Sheet. Sometimes there is added to this a percentage to cover establishment charges—such as the wages of foremen, store-keepers, yardmen, and mechanics; fuel, power, heating, lighting, depreciation of plant, etc., and to a reasonable extent this

is permissible. However, each case must be considered on its own merits, and for stocktaking purposes the percentage added to cover establishment charges should be kept as low as possible, and should cover works expenses only, and never administration expenses, such as directors' fees, debenture interest, staff salaries, travellers' salaries, commission and expenses, office rent, rates and taxes, etc. It is true that these latter expenses should be taken into account for cost account purposes, but they should not be added for stocktaking purposes. Under no circumstances, however, may partly or completely manufactured stock be valued at a figure above that at which similar goods can be purchased, for, in the case of newly-started works, it is sometimes found that the actual cost of manufacture exceeds the selling price, and in such circumstances, of course, the cost price could not be adopted for Balance Sheet purposes.

The auditor's position as regards stock-in-trade is one of very great difficulty, for the amounts involved often are very considerable and materially affect both the Profit and Loss Account and the Balance Sheet, and the fraudulent falsification of accounts is most frequently effected by means of the stock. But it is impossible for the auditor himself to take, inspect, or value the stock, and unless stock books have been kept, the books of account do not disclose what stock should be in hand at the date of the Balance Sheet. Further, there is no certain means by which he can verify the existence of this asset, as in the case of such assets as cash in hand, bank balances, investments, freehold and leasehold properties, etc. In fact, the auditor has less control over this asset than he has practically over any of the other assets of a business, and he is bound to rely very largely upon the internal checks in this connection, and upon the certificates given by the management—in fact, the stock presents one of an auditor's greatest difficulties.

The principal errors that have to be guarded against, all

of which may be purposely or unintentionally committed, are as follows—

Incorrect additions and calculations.

Incorrect prices and valuations.

The inclusion of goods in stock, the invoices for which have not been passed through the purchases.

The inclusion of goods in stock that have already been sold and entered as sales, prior to the date of the Balance Sheet.

The omission of stock in the hands of agents, at docks, in warehouse, etc.

The inclusion of plant, tools, furniture, etc., in stock, which have already been debited to an asset account.

The omission to provide for depreciation in the case of damaged, out of fashion, or obsolete stock.

If proper stock accounts have been kept, these will be of great assistance to the auditor for the purpose of checking the stock, and any large differences between the quantities shown by the stock books and the stock sheets should be most carefully investigated.

Before commencing the actual checking, the auditor should carefully enquire into the whole system of taking, entering, pricing and checking stock, and find out the exact basis upon which it has been valued. As many persons as possible should be engaged upon the stocktaking, and each step should be independently checked. Further, responsible officials should supervise the work, as juniors often have quite erroneous ideas concerning what is rightly included in stock, and the principles governing its valuation. Each person who takes part in the stocktaking should initial the sheets for what he has done, and a responsible official, such as a managing director or partner, should give an over-riding certificate to the effect that the stock has been correctly taken, is valued in all cases at cost or under, and that the total of the stock represents a fair and proper valuation of this asset.

In the case of a manufacturing business, the auditor

should make most careful enquiries as to the valuation of the partly-made and finished goods, and as to the whole system for dealing with this, in many cases, most complicated matter. In some factories, goods may pass through twenty or more distinct stages of manufacture before they are completed, and in each stage, wages and materials are being expended. Therefore, it will be appreciated that at the date of the Balance Sheet, in the ordinary course, there will be goods at every stage, and that the cost in each stage will be different. Unless proper cost accounts have been kept, it is practically impossible correctly and accurately to value partly manufactured goods, as the only means of checking that an auditor has is the comparison of the stock valuations with the cost records, which records should show the exact cost of each stage in the process of manufacture. In any event, the auditor is bound to be very considerably in the hands of the management, as there are practically no independent checks possible, except cost records, and the comparison of the percentages shown by the accounts of other years; and even these latter are not conclusive, but may only lead the auditor to the conclusion that the stock valuations are unsatisfactory.

Having enquired into the whole system of stocktaking, and the internal checks with regard thereto, the auditor should check and test the stock sheets as far as possible, and the lines upon which he should carry his investigations should be as follows—

Check the castings, or a considerable portion thereof, bearing in mind that there is no double entry check upon these totals.

Check a proportion of the calculations, selecting the larger items.

Compare the stock sheets with those of the previous year, especially as regards prices and quantities, making careful enquiries if important fluctuations occur, and also with a view to ascertaining whether any part of the

stock has been in hand for long periods, and may thus be out of date or obsolete.

In the case of raw materials and purchased goods, compare prices with recent invoice and market prices.

Examine the Goods Inwards Book for the last few weeks of the period, and trace all large items into Stock and into Bought Day Book.

Trace any large sales towards the end of the period into the Goods Outwards Book, and if any of these sales did not leave the works until after the date of the Balance Sheet, see that these goods have not been included in stock.

In the case of partly and completely manufactured goods, test the same with the Cost Book records, and see that any additions for establishment charges are reasonable. If there are no Cost Books, see that full particulars are given as to how the figures are arrived at, and that these are certified by a prominent official. Test these items as far as possible with any available evidence.

If Stock Books are kept, check the quantities with the Stock Book balances, carefully enquiring into any important differences.

In some businesses the quantities in stock can be checked easily, as, for example, in the case of a coal merchant, the Bought and Sales Day Books should be ruled with quantity columns, and thus the total tonnage sold during the period, deducted from the tonnage in stock at the commencement, plus the tonnage purchased, should give the quantity in stock at the end of the period. There will be always small differences owing to waste.

Enquiry should be made as to whether there are any goods in the hands of agents, at the docks, or warehouse, etc., that may have been omitted from the stock sheets.

When examining the stock sheets it should be seen that no plant, tools, furniture, etc., are included.

When the Trading Account is completed, the auditor

should compare the percentage of gross profit to sales with that of previous years, and if there are any marked fluctuations, enquire into the reasons. Such fluctuations in the percentages may be accounted for by variations in prices of sales, purchases or wages, to exceptional contracts, or to improved production, but if the auditor is not satisfied that the fluctuation is caused by one or other of these circumstances, it must be that the opening or closing stock is incorrect, or that the opening and closing stocks have been taken upon a different basis. This percentage test is of very great value, but it cannot be applied in all cases, as in some businesses there is no constant percentage of gross profit—the gross profit made on the individual transactions varying considerably.

The foregoing are tests that may be applied to the stock-in-trade, but an auditor can never be absolutely certain that this item is correct, and he is bound to depend to a considerable extent upon the certificate of the management. But he must exercise reasonable care and skill in order to satisfy himself that the stock has been correctly taken and valued, and, therefore, he must make exhaustive enquiries and test the stock sheets as far as he can in the circumstances of the particular case, and if he is not completely satisfied, he should, without fail, deal with the matter in his audit report.

The legal responsibility of auditors as regards stock-in-trade is a question of considerable importance, and is dealt with later in Chapter X. In the meantime, it should not be thought that it is suggested that an auditor *must* apply all the above tests in every case, but that, realising what an important bearing the valuation of stock has upon the accounts, how easy it is to falsify the accounts through the stock, and how difficult it is for the auditor to verify this item, it is most advisable that an auditor should pay particular attention to this asset, and endeavour to verify it as far as he possibly can within reason, and that he should not rest content with complying with what

may appear to be the strict legal requirements in this direction.

Goods on Consignment. This asset should be very carefully verified, and it should be seen that proper accounts are kept with reference to each consignment, that is to say, that in each case there should be a Consignment Account and a Personal Account with the agent, the former being practically a Trading Account showing the profit or loss upon the particular consignment, and the latter comprising amounts due to or by the agent.

The duplicates of the debit notes should be compared with the Consignment Account, so as to ensure that the goods have been debited at cost price. The accounts sales received from the agent should be checked, to see that the gross sales have been credited to the Consignment Account and debited to the agent, and that the agent's expenses and commission have been debited to the Consignment Account and credited to the agent's account.

If at the date of the Balance Sheet the whole of the goods have not been sold, the agent should send certified stock sheets showing the goods in hand at that date, and the auditor should carefully examine these stock sheets. The stock should be valued at cost price, plus freight and charges, full allowance, however, being made for depreciation if goods have deteriorated or been damaged. The stock valuation will be brought down as a debit balance upon the Consignment Account, and if a loss has been incurred upon the goods sold to date, it must be written off to Profit and Loss Account, and must on no account be brought down in the balance upon the Consignment Account. The figure in the Balance Sheet should represent only the stock in hand at a fair valuation.

If the Consignment Accounts have not been kept as suggested above, these transactions will require very careful scrutiny, especially in order to see that no profit has been anticipated in respect of goods sent to agents, but not yet sold; that any losses to date upon goods sold

have been written off; that stock unsold is brought into the Balance Sheet at a fair value; that all expenses and commissions due to agents have been provided for; and that balances due from agents are shown separately upon the Balance Sheet, and are not included among Sundry Debtors.

The auditor should make enquiries to see that ample reserves have been provided for possible bad debts, and, therefore, any long-standing debit balances upon the agent's or Consignment Accounts should be most carefully enquired into. In the case of businesses selling goods abroad in this way, the losses at times, owing to the default of agents, are very considerable, and, therefore, great care should be exercised when dealing with these transactions.

Work in Progress. Partly manufactured goods have been dealt with above under the head of Stock-in-Trade, and what is meant by work in progress for present purposes is, for example, uncompleted contracts, in the case of builders, engineers, shipbuilders, and such like businesses. For Balance Sheet purposes, the general rule is that work in progress should be valued at cost—that is, the wages, materials and direct charges expended thereon to date, and, in addition, a reasonable sum for "oncost," that is, a percentage added to cover the various indirect charges of the business, such as supervision, factory, rent, rates and taxes, power, depreciation of plant and machinery, cartage, indirect wages, such as those of foremen, storekeepers, yardmen, etc. A percentage is also sometimes added to cover administration expenses, such as directors' fees, debenture interest, staff salaries, office rent, rates and taxes, etc., though for Balance Sheet purposes it is wiser to omit these latter. In this way, the actual cost of the work to date is carried forward to the succeeding period, and no profit is taken credit for in respect thereof. If, however, it is anticipated that eventually a loss will be incurred upon any contract, then the cost figure must be reduced, so that such loss is provided for.

In the Balance Sheet, the work in progress should be shown as a separate item, and any cash received on account thereof should be deducted.

In practice, profit is sometimes anticipated, and although, theoretically, this is not correct, it is a well-known custom which in proper circumstances an auditor may pass. This practice is commonly adopted in the case of large contractors, where the individual contracts often extend over periods of some years. If, therefore, they only took credit for the profits when the contracts were completed, the results shown by the general Profit and Loss Account would vary very considerably from year to year, for in one year a number of profitable contracts might run out, with the result that the Profit and Loss Account would show a large profit, but in another year, though there might be several large and profitable contracts running, and in respect of which considerable sums of cash have been received on account, yet very few contracts might have been actually completed during the period, and, therefore, owing to the Profit and Loss Account having to bear considerable standing charges, the accounts might show a loss. Therefore, to average the results, profits are anticipated. But, where this is done, very great care must be exercised in estimating such profit, and ample reserves must be made for contingencies, for it must be borne in mind that a contract may be progressing normally, and present figures indicate that a considerable profit will be earned, but some unforeseen contingency may arise, such as a strike, collapse of part of the works, rise in the price of raw materials, flooding in the case of the building of a tunnel, failure to complete in the contract time and thereby incurring heavy fines, and many other such circumstances, which may result in the contract eventually showing a considerable loss.

Profits should be anticipated only when the contract is so far advanced that the cost to complete can fairly be estimated, and thus the probable eventual profit arrived

at. Therefore, all contracts that are in an early stage should be invariably valued at cost. When the results of the contract can be reasonably estimated, a heavy reserve should be deducted for contingencies; for example, the proportion of the final profit, according to the work completed to date, should be calculated, and about one-third of such profit should be reserved, the remaining two-thirds only being taken credit for. Another most important point is, as to whether the cash received under the contract has been sufficient to warrant the anticipation of profit, for if, for example, the cash received is less than the actual expenditure upon the work to date, and there is no cash payable in the immediate future, then if a profit is anticipated, upon the strength of which dividends are paid to shareholders, or profits paid out to partners, the result of such payment of dividend or profit, must be that the working capital of the concern is reduced by reason of this anticipation and withdrawal of profits that have not been, in fact, received in cash. Therefore, the cash position should be considered most carefully in all cases, and in a small business, having only a small working capital, it is a very unsound policy to anticipate profit upon uncompleted contracts at all, as the result may be that the working capital is reduced, and a serious financial position thus created, there not being sufficient funds in hand to complete the contracts. Large contracts require very careful financing, and, therefore, this point should never be lost sight of.

The auditor should go into the whole question of work in progress most carefully, comparing the Balance Sheet figures with the Cost Books. If proper Cost Books have been kept, these will be of great assistance, especially if they have been subject to an efficient internal check, as in such case they will afford a very valuable check upon the work in progress. If, however, there are no reliable Cost Books, the auditor should insist upon full particulars being included upon the work in progress sheets, showing

exactly how the results have been arrived at, and these he should check as far as possible with whatever evidence there is available.

The auditor should check the castings and test the calculations of the sheets, see that the latter have been initialled by all who have taken part in their preparation, and that the work in progress is certified as a whole by a responsible official. The auditor should carefully enquire into the whole system for valuing this item in the Balance Sheet, and the basis upon which such valuation has been made. He should carefully enquire into any "oncost" added. If profit is anticipated, he should investigate the figures most thoroughly, and in this case he should insist that the accounts should disclose the fact that the work in progress includes anticipated profit; if they do not, he should point out this important fact in his audit report.

The auditor is bound to be very much in the hands of the management when dealing with this asset, but he should endeavour to check and test the figures as far as he reasonably can, and if he is not absolutely satisfied, he should report to that effect to the shareholders or partners, as the case may be. If the work in progress has been falsified deliberately by, say, the managing director, in all probability it will be impossible, in the ordinary course of an audit, to discover the whole extent of this fraud, but careful and intelligent investigation may be sufficient to lead the auditor to the conclusion that the valuation of this asset is unsatisfactory, and that the results are not reasonable, and if, therefore, he reports to this effect, the shareholders, in the case of a company, may thereupon institute a much fuller investigation, which may result in the true facts being ascertained.

Plant and Machinery. Plant and machinery is not valued upon the basis of its realisable value, but upon the basis of its value to the particular business as a going concern; in other words, the value is based upon its earning capacity, and not upon its intrinsic value.

The cost price of plant and machinery, less any "scrap" or residual value, should be written off to revenue over the period of the estimated working life of the asset. The estimated working life is, of course, the unknown factor, and it requires the technical knowledge of an engineer to fix this period, and in this respect the auditor must be almost entirely in the hands of the engineer.

The market values of similar machinery may be disregarded, for the plant of a manufacturer is held solely for the purpose of manufacturing with the same for the whole of such asset's working life, and this period is unaffected by fluctuations in the market prices. The "break up" or realisable values are also disregarded, for this asset is not held with a view to re-sale. A considerable portion of the plant and machinery has, as a rule, very little realisable value; for example, shafting, if pulled out, will realise a very small proportion of original cost. Again, machinery specially manufactured for a patent process might be of no value to any other concern. New machinery that has been just installed, immediately becomes "second hand," and the realisable value is considerably less than cost.

All these circumstances, therefore, are disregarded, and, provided that the cost price is written off to revenue by means of depreciation over the period of the asset's working life, during which it is earning income, the balances appearing in the accounts of intermediate years are absolutely correct ones, according to the accepted rules upon which Balance Sheets are prepared. By means of depreciation, profits are withheld and retained in the business to replace the capital that has been sunk in the purchase of the plant, which capital otherwise would be lost upon the expiration of the life of the asset.

In some cases, plant and machinery is re-valued each year for Balance Sheet purposes, in which case, the certified valuations should be produced to the auditor, but this practice is very uncommon. However, it is a very good

plan indeed to have plant re-valued occasionally, in order that the amounts of depreciation written off may thus be roughly checked. For it must be borne in mind that it is quite impossible to fix, with absolute certainty, the period of the working life of plant, machinery, and similar assets.

The verification of this asset by the auditor is a matter of some difficulty; in fact, it is impossible to verify this item with any degree of certainty, as is the case with some of the other assets. Upon the purchase of the individual items, the auditor will vouch the payments in the ordinary way with invoices, receipts, etc., and all additions during the period of the accounts should be thus vouched, careful enquiry being made to see that such items do, in fact, represent *bonâ fide* additions to capital. Replacements also must be carefully enquired into, with a view to ascertaining that the old asset has been entirely written out of the Plant Account before the new asset is debited in its place.

There should be a plant register, or a schedule of the plant and machinery certified by the engineer, and, if so, this should be called for by the auditor. If possible, the auditor should ask to be shown round the works, when he can roughly count the large items, such as boilers, lathes, etc., and thus verify their existence, and that the plant and machinery appears to be in working order.

In the case of plant and machinery abroad, the auditor should require that the local engineer should furnish a report upon the plant as at the date of each Balance Sheet, reporting as to whether the same is in a proper state of working efficiency, and also as to the adequacy of the provisions for depreciation.

The auditor should discuss the whole question of depreciation fully with the management, and thus endeavour to ascertain the basis upon which they have based their estimates and provisions, and whether they have acted upon proper advice. It is impossible for an auditor to value or estimate the working life of plant; all he can do

is to make enquiry and thus satisfy himself whether or not this most important question has been properly faced and considered, that correct principles have been acted upon, and that the provision made in the accounts appears to be reasonable and sufficient. It is often found that the provisions for depreciation have been fixed haphazard, and without regard to any of the considerations and principles governing the question, and, in such cases, and when the auditor is not satisfied that the depreciation is sufficient, he should point this out clearly in his report.

The whole question of depreciation will be considered at length in Chapter VI, but the foregoing will perhaps be sufficient to indicate the lines upon which an auditor should deal with this asset in a Balance Sheet.

Loose Tools, Etc. As the working lives of the various items coming under this head, in many cases, are very short, and replacements, renewals and additions are constantly having to be made, the only really satisfactory way to deal with this asset is to make a re-valuation each year, in which case this item is dealt with in the same way as stock-in-trade, the auditor examining the certified valuations, and checking and testing the same as far as possible.

Furniture, Fixtures and Fittings. Furniture should be dealt with as in the case of plant and machinery, and an adequate depreciation should be written off, based upon the working life. The depreciation of such as safes, desks, tables, etc., is very small, and such assets always have a fair realisable value, but fixtures and fittings, such as partitions, bookshelves, electric wiring and fittings, have practically no realisable value, but may be written off according to their estimated lives, except in the case of fixtures and fittings upon leasehold premises, in which case the whole should be written off over the period of the lease.

Horses. Horses should be re-valued each year, the certified valuation being produced to the auditor, or the

average working life of a horse should be estimated, which, for example, in the case of cart horses working in a city is generally reckoned to be about five or six years. A Horse Register should then be kept, in which each horse is entered when purchased, full particulars as to age, description and cost being given; each year the value of each horse should be reduced by (say) one-sixth of the original cost price, and in this way the total depreciation is arrived at. Upon death or sale, after crediting in the register any amount realised upon the sale of the carcase or live animal, any resulting debit balance should be written off as a loss. In the event of profits being made upon sales, these should be credited against losses upon death or sales. The Horse Register will show the details making up the balance upon the Horse Account in the Ledger, and should be examined and compared therewith by the auditor, who should also see, in the light of actual experience, whether the estimated working life appears to be working out correctly.

Carts and Vans. Carts and vans should be dealt with in the same way as plant and machinery, and owing to the extent to which the working life may be extended, by means of repairs and renewal of parts, the rate of depreciation may be small. But in the case of motor vans, the depreciation of the engines is fairly rapid, and as the initial cost is considerable, the methods applied to these should be carefully enquired into by the auditor.

Harness. Harness should be dealt with in the same way as loose tools, and re-valued, and in practice sometimes each complete set of harness is valued each year at a fixed value, such fixed amount being a low average value, and new and old sets are all valued at the same average figure. Provided the fixed valuation is low enough, this latter is a very simple and effective way of dealing with this asset.

Freehold, Copyhold and Leasehold Land and Buildings. Land should appear in a Balance Sheet at cost price, and

should not be written up, even though the neighbourhood may be improving and values increasing, for, in the case of land upon which a factory or works stand, it is not held with a view to re-sale, and no profit has been made unless and until such land is sold. In the meantime, any increase in value is a mere estimate, which may or may not prove to be correct, if and when such land may be sold. On the other hand, should values be going down, it is not the general custom to reduce the Balance Sheet figure, for the earning capacity of the works is not affected, and no loss will be occasioned unless a sale takes place. Land, therefore, generally appears at cost price, and this should be stated clearly on the face of the Balance Sheet.

In the case of buildings upon freehold land, a certain amount of depreciation should be written off—the rate will depend upon the nature of the building, its age, and state of repair; but although the length of life, in the case of a first-class building, is long, yet a certain amount of structural renewals is inevitable from time to time, and should, therefore, be provided for in advance, otherwise the cost of such renewals will create a considerable burden upon the year in which they take place, when the whole will have to be borne by that year's Profit and Loss Account.

The cost of leasehold property must be written off to Profit and Loss Account over the period of the lease, for at the end of this period the property reverts to the lessor. In the case of buildings, provisions should also be made for dilapidation claims that may be made upon the expiration of the lease.

As regards verification, in the case of freehold property, the auditor must inspect the title deeds and see that the same appear to be in order, and refer to the particular property. He should inspect the abstract of title which gives the dates and parties to the various conveyances, seeing that such conveyances are there, and that the last conveyance is in to the name of his clients. An auditor

cannot guarantee that the title is good; all he can do is to see that the deeds are in possession and appear to be in order; if in doubt upon any points, he should refer to the client's solicitors.

In the case of copyhold land, there will be no title deeds, and the auditor should call for the certified copy of the Court Roll of the Lord of the Manor.

Leasehold property will be verified by an inspection of the counterpart of the lease, the terms of which should be noted, and the receipts for the last payment of ground rent and the premiums paid under the current fire insurance policies should be called for, in order to ascertain that these are not in arrear.

If property has been mortgaged, the title deeds will be in the possession of the mortgagees or their solicitors, and, in this case, the auditor should apply direct to them for a certificate that they hold the deeds of the particular property as security for the advance, the amount of which and the date to which interest has been paid should be specified.

Loans. In the case of advances upon mortgage, the mortgage and title deeds will be inspected, and it should be seen that the interest has been paid to date. If a valuation of the property were made at the time of the advance, such valuation should be inspected to see that the loan appears to be sufficiently secured.

With other loans, the auditor should inspect the written acknowledgment of the debt and any security that may have been lodged; he should also see that the interest is regularly paid, and that a sufficient reserve is made for bad debts. In the case of a company, he should see that the articles give power to make advances, and inspect the directors' minute authorising the same. If directors have made advances to individual members of the board, the auditor should insist upon such loans being shown separately upon the Balance Sheet; if they are not, he should refer to the matter in his audit report.

Patents. The life of a patent is only fourteen years, and, therefore, the cost of acquiring the same should be written off over this period. The cost of all renewal fees should be debited direct to Profit and Loss Account.

The auditor should call for a list of all the patents, giving particulars of each patent, the registered number, dates, etc., and he should inspect the patent itself, and the receipt for the last renewal fee, to see that the same has been paid to date.

Copyrights. A copyright lasts for the lifetime of the author, plus seven years, or for a period of 42 years from the date of publication, according to which period is the longer. The cost of publication cannot, however, be written off over the whole of this period, as in the majority of cases the value expires long before the end of the time. The only practical method, therefore, is for the copyrights to be re-valued each year.

There is no document of title in this case, proof of first publication constituting a copyright. The auditor should inspect the valuations, and see that this asset appears to be taken at a fair value.

Goodwill. Goodwill should not appear as an asset in a Balance Sheet, except in the case of purchase, when it should appear at cost price. If the price paid for goodwill has not been fixed specifically, the amount will be the difference between the total purchase price and the assets at the agreed valuations, less any liabilities taken over from the vendors. Goodwill should appear in the Balance Sheet as a separate item, and should be described as being "at cost," if that is the case.

Questions are often raised as to whether depreciation should be written off this asset, and although this is undoubtedly a very wise course to adopt, it cannot be considered to be, either from a legal or from an accountancy point of view, compulsory. Goodwill is a very peculiar asset—it is inseparable from the business, and it is unlike such assets as plant and machinery, etc., in that it does

not have to be renewed or replaced, and it is not depreciated or worn out in the course of earning income.

The figure at which goodwill appears in a Balance Sheet does not purport to show its present value, but merely the amount that has been expended in its acquisition, or, in other words, the amount of capital that has been invested in this particular asset.

The present value of the goodwill of a business must depend entirely upon the financial position at date, and the present earning capacity and prospects of the concern, and a purchaser would not be influenced in the least by the value placed upon this asset in the Balance Sheet. If the profits are large and increasing, and part thereof is used to write down the value of the goodwill, its value will in reality be increasing, whereas, if the profits are small, or losses are being incurred, it will be impossible to write down the goodwill, the value of which, in this case, would be decreasing. Again, a business that is doing very badly to-day, and whose goodwill may not be worth anything like the original cost price which appears in the Balance Sheet, in the future may be converted, through new management, into a most flourishing concern, with a very valuable goodwill.

Goodwill is a very intangible asset, and it is, therefore, a very sound policy to write the cost down if profits are available, and in this way ensure that the whole of the capital of the business is represented by tangible assets; but this is a matter entirely for the proprietors of the business to decide for themselves, and an auditor cannot interfere, though he may give advice if specially asked to do so.

The auditor should see exactly how the balance upon the Goodwill Account is made up, and that it does represent the actual cost only, no improper items having been debited thereto. He should see that it is separately stated in the Balance Sheet and described as being "at cost." Apart from this he is not concerned, the Balance Sheet showing

clearly what is the position of affairs. He cannot insist upon this asset being written down out of profits, unless, in the case of a company, the articles specially provide to this effect, but, on the other hand, goodwill should on no account be written up.

The effect of writing down goodwill out of profits is to retain in the business profits that would otherwise be available for distribution, and, in this way, the working capital of the concern is increased. Exactly the same result can be arrived at by the creation of reserves, disclosed upon the Balance Sheet. In the opinion of many, this latter is the better course to adopt, as the exact position is more clearly shown in the Balance Sheet, for by writing down goodwill out of profits, in effect a secret reserve is created, and, moreover, the Balance Sheet does not make it clear that additions are being made to the working capital.

CHAPTER VI

DEPRECIATION, RESERVES AND SINKING FUNDS

Depreciation

THE subject of depreciation is one of the most important, and at the same time difficult matters, with which an auditor has to deal; therefore, it is proposed to discuss this question here, and to point out some of the important points that must be borne in mind by an auditor But it is impossible in the space available to deal completely with the whole of this subject, and all accountant students are strongly advised to study it exhaustively in all its bearings, for it is thought that considerably more attention will be paid to this question by the commercial world in the future, than has been the case in the past—therefore, every auditor should be well versed in all the governing principles.

In practice, the term "depreciation" is commonly used in a very wide sense, covering decreases in the values of assets caused by outside fluctuations in market values, and also the shrinkage in value caused by the wearing out of an asset owing to its use in the business.

FLUCTUATIONS IN THE MARKET VALUES OF FIXED ASSETS. Fluctuations in the value of fixed assets are not generally provided for when preparing the accounts of a business, for these fluctuations are caused by outside factors in no way affecting either the earning capacity or the actual revenue earnings of such assets. For example, in the case of land upon which a factory is built, the market fluctuations in the value of such land are properly disregarded, for this asset is not in the market for sale, but is held merely for the purpose of providing the space upon which to erect the buildings necessary for the purposes of the business. The trading results of the concern, and the earning capacity of this asset are, therefore, in no way

affected by such outside fluctuations in value. Consequently, an asset of this nature appears in the Balance Sheet "at cost," so that in this way is shown how much of the original capital was sunk in the acquisition of this property.

If fixed assets, such as investments, are held, and it is anticipated that they will be sold in course of time, then, if market values appear to have fallen permanently, and therefore, it appears that losses upon realisation will be incurred, it is wise to hold back part of the profits and thus provide a reserve against this contingency, and ensure that the original capital sunk in the investments is kept intact.

Fluctuations in the Market Values of Floating Assets. In the case of decreases in the market values of floating assets, such fluctuations, if of a temporary nature, may be disregarded, but if this fall in market prices is likely to be more or less permanent, and to affect selling prices, so that it appears unlikely that the goods will be sold at a profit, then, as a trading loss appears to be inevitable, such stock should be written down, and the loss thus anticipated, and brought into the year when the bad purchase was made.

Depreciation of Wasting Assets. The depreciation that must be provided for, if accurate accounts are to be prepared, is the shrinkage in value of assets that is caused by, and is the result of, using such assets for the purpose or earning revenue. In this case, the shrinkage in value is the natural and inevitable result of employing the asset for the purpose of earning revenue. For example, in the case of plant and machinery, manufacturing therewith necessarily has the effect of gradually wearing out the machines. Such depreciation does affect the earning capacity of the asset, and the correct trading profits are not ascertained unless a proper charge is made for the machinery used. Therefore, depreciation should be provided for in the case of all wasting assets, that is, assets

that are used up or exhausted in the course of seeking to earn income, examples being, buildings, plant and machinery, furniture and fixtures, horses, carts, vans, and harness, leases, patents, copyrights, etc.

THE MAIN OBJECT OF PROVIDING FOR DEPRECIATION. The main object of providing for the depreciation of wasting assets is to keep the capital intact. As part of the capital of the concern has been invested in the purchase of these assets, which have a working life of only a limited period, therefore, when this working life comes to an end, and the earning capacity of these assets ceases, they will become valueless for the purposes of the business, and the original capital sunk in their acquisition will have been lost. Hence, in order to keep the capital of a business intact, if any part thereof is invested in the purchase of wasting assets, profits must be held back by means of depreciation charges to Profit and Loss Account, in order to replace the capital that is being lost by reason of the fact that it is represented by assets that are being consumed or exhausted in the course of trading or seeking to earn income. For example, in the case of a factory, in order to produce the finished goods that are sold, it is necessary to use raw materials, labour *and machinery*, and the cost of the machinery is just as much a charge against the profits earned as are the materials and wages. If to manufacture certain goods one machine alone was necessary, and that machine was purchased at the commencement of the financial year of the business, but the working life of this machine was one year only, then, in this case, when calculating the profit or loss upon the goods manufactured, against the sales there would have to be charged the cost of production, which would be the cost of the materials used, the wages, and the cost of the machine which had been used up in the course of the manufacture. The cost of the machine is just as much part of the cost of producing the finished goods as the materials and wages, for in order to convert the raw materials into the saleable

articles, both the machine and the labour and materials are necessary. In this way, out of the amount realised upon the sale of the goods, there is held back the cost of the machine, and thus the capital sunk in its purchase is replaced; whereas, if this were not done, the effect would be that a loss of capital, directly caused by the manufacture, would not have been provided for, and the available capital of the business would be permanently reduced thereby, the result being exactly the same as if the cost of the labour had not been charged. The foregoing is, of course, a very simple case, but exactly the same principles apply where the machinery lasts for a period of years; and so, as the plant will continue to be used for a number of years, its cost has to be spread over this period. In this way, during the life of the machinery, out of the income earned thereby, there will be held back the original cost of the same, and thus the capital invested in this wasting asset will be replaced, such capital being available for the general purposes of the business, or for the replacement of the worn-out asset.

In all cases, therefore, where one of the direct causes of earning revenue is gradually to consume fixed assets of a wasting nature, the depreciation of such assets should be provided for out of revenue. For the cost of such assets is, in fact, a direct revenue charge, but it is one that, in most cases, has to be spread over a period of years, as the benefits arising therefrom are not all exhausted in the one year, as is the case with the majority of revenue charges, such as rent, rates, taxes, salaries, etc.

Obsolescence and Effluxion of Time. Other factors which have the effect of exhausting the value of assets are obsolescence and effluxion of time. Obsolescence, in the case of plant, means that new and improved machinery has been invented, which will manufacture better, cheaper, or in greater quantities, and, therefore, if these new machines are widely adopted in the particular trade, the old plant must be "scrapped" and the new machines

installed, as otherwise the particular business will not be able to compete successfully with its rivals, and thus keep its place in the markets. Therefore, in fixing the working life, this eventuality should be considered, and the period fixed should be the period during which it is estimated that the machinery will be suitable for the purposes of the particular business, and will be able to manufacture the required standard of articles in sufficient quantities, and at a cost that will enable the business to hold its place, and to compete successfully in the markets. Effluxion of time is a factor in such cases as leases, where at the end of a fixed period the lease terminates, and all value, therefore, ceases. The amount paid for a lease is, in effect, the capitalised value of rent paid in advance, and must, therefore, be written off to revenue over the period of the lease, as also must the cost of any buildings erected upon leasehold land, and any improvements effected by the lessor.

Estimation of the Working Life of Plant and Machinery. The difficulty in dealing with the question of depreciation of such assets as plant and machinery is that the working life has to be estimated, and there is no certain way of arriving at this period; therefore, past experience and expert and technical knowledge are required when dealing with this point. In practice, it is generally found that the cost of all the plant and machinery is included in one account, in which case it is impossible to estimate the depreciation accurately, for the lives of all the various classes of machinery, etc., included under the one head will be different; for example, boilers and such like heavy plant may last for a number of years, but fast-running machines may have a very short life only, and such accessories as belting will have to be renewed constantly. In the above circumstances, therefore, the fixing of the depreciation is a mere matter of guess-work, the accuracy of which can only be proved or disproved in the light of after years. If, then, as is very probable, it is

found subsequently that the depreciation has been underestimated, the evil will have been done, in that profits will have been overstated, and if, furthermore, such profits have been withdrawn, part of the capital of the concern will have been lost. Such circumstances have in many cases been the chief cause of bankruptcy, as it has been found impossible to replace the capital that has been lost owing to the inadequate provision for depreciation.

Plant Register. The only really satisfactory method for dealing with the depreciation of plant and machinery is to keep a special "Plant Register," in which a record is kept of each machine. The whole of the plant and machinery should be split up into classes, so that only items with approximately equal working lives would be grouped together. Full particulars should be entered in connection with each machine, and a special column should be provided in which should be entered the cost. The "scrap value" and the working life of each should be estimated and entered in the register, and a number of columns should be provided for the annual amounts written off for depreciation, which should be an equal amount each year, so that the cost less the "scrap value" is written off over the estimated period of the assets' working life. In the light of actual experience, these estimates should be constantly revised, so that as far as possible absolute accuracy is attained. At the end of each financial period, summaries should be prepared from the registers showing in totals, as regards each class of machinery, the opening balance, the total depreciation written off, and the closing balance. The Plant and Machinery Accounts in the Impersonal Ledger should be adjusted to agree with such summaries. Upon the sale of a machine, the amount realised should be credited in the register, and any debit balance written off as a loss upon sale.

The foregoing method may appear to be unduly complicated, but once the register has been written up, it will

be necessary only to keep it up to date, and this will not entail a great amount of labour. On the other hand, it will be possible to deal with the question of depreciation, which so materially affects the accounts, with a degree of accuracy which otherwise is quite impossible; and, further, most valuable practical information as regards the various machines can be accumulated, which will be of very great assistance to the management.

Cost of Maintenance and Maintenance Reserves. The cost of maintenance, such as repairs and small renewals, should be charged direct to revenue, and if these charges vary considerably from year to year, it is a very good plan to create a Maintenance Reserve Account, so that the annual charge to revenue may be equal. To effect this, the average annual charge under this head over a long period of years should be arrived at, or, if such material is not available, expert advice should be sought, and this average amount should be debited each year to Profit and Loss Account, and credited to the Maintenance Reserve Account. As the repairs take place, the cost thereof should be charged direct to the Maintenance Reserve Account, and if the estimate has been correct, the credit balance upon this account should be sufficient to provide for these charges. The credit balance upon the Maintenance Reserve Account should be carried forward as a separate item upon the Balance Sheet. If this account shows a debit balance, this would mean that the annual provisions have not been sufficient, and, therefore, such debit balance should be written off to Profit and Loss Account, and this question reconsidered, and the annual provision accordingly increased. It may be, however, that in the first few years, before the reserve has had time to accumulate, the actual charges may outweigh the credits, and, in such circumstances, if it is reasonably certain that the credits in the next few years will bring the account into credit, a debit balance might be carried forward, but, in this case, this item would have to be

separately stated and clearly described in the Balance Sheet. However, as a general rule, and except in very exceptional circumstances, a debit balance should never be allowed upon a Maintenance Reserve Account.

Methods for Writing Off Depreciation. The various methods used in practice for writing off depreciation are as follows—

FIXED INSTALMENT SYSTEM. Under this system a fixed percentage, *calculated upon the original cost price of the asset*, is written off each year; for example, in the case of an asset costing £1,000, the working life of which is estimated to be ten years, the depreciation charge each year would be 10 per cent. on £1,000, that is, £100 per annum. This method is not commonly used in connection with plant and machinery, as it is necessary to make a separate calculation in respect of all additions, but if a "Plant Register" is kept, as suggested above, it can easily be adopted, and, in the opinion of the author, it is the most effective and accurate method of calculation. This method is commonly used for writing off the cost of short leases, in which case there is no question of additions, and the period of life is known exactly.

REDUCING INSTALMENT SYSTEM. Under this system a fixed percentage is written off each year, *calculated upon the reducing balance brought down upon the asset account.* That is, if 10 per cent. is being written off an asset costing £1,000, the depreciation written off in the first year will be 10 per cent. on £1,000, that is, £100; in the second year it will be 10 per cent. on £900=£90; and in the third year 10 per cent. on £810 = £81, and so on. It will be seen that the amount written off becomes less each year, and it is suggested that, in the case of such assets as plant and machinery, this decreasing charge for depreciation is justified, as the cost of repairs will be increasing each year as the plant grows older, but, in the author's opinion, it is far better to deal with the question of repairs apart from depreciation, by the creation of

maintenance reserves. This method of writing off depreciation is the one most commonly used in connection with plant and machinery, as it is simple, and separate calculations do not have to be made in the case of additions, as such additions increase the balance upon the Plant Account, and the percentage is calculated upon this increased figure. The great weakness of this system is, that it takes a very long time to write an asset down to approximately nil, unless a very high rate is used, in which latter case the burden upon the opening years is excessive. For example, if an asset costing £1,000 is depreciated at 10 per cent. under this system, at the end of forty years there will still be a balance of £14 upon the asset account, and to write £1,000 off over a period of ten years, the rate will have to slightly exceed 25 per cent., but taking 25 per cent., the charge for depreciation at the end of the first year will be £250; for the fourth year it will be £105; for the sixth year, £60; and the ninth year £25—so that it will be seen what an enormous charge is placed upon the first year or two, and how rapidly the charge in succeeding years reduces. These facts are seldom appreciated when this system is adopted in practice, and the rate fixed is generally quite inadequate to write the asset down in a reasonable period; therefore, when this system is adopted, an auditor should see that the rate per cent. is sufficient to write the asset down during the period of its estimated working life.

Depreciation Fund System. Under this system, during the period of the estimated life of the asset, an equal amount is written off each year for depreciation, Profit and Loss Account being debited, and a Depreciation Fund Account being credited; at the same time a similar amount of cash is withdrawn from the business, and should be invested in "gilt edged" securities, cash being credited and an Investment Account debited. The interest yielded by the investments, as received, will be debited to cash and credited to the Depreciation Fund Account; at the

same time this interest should be re-invested, cash being credited, and the Investment Account debited. After all interest received has been re-invested, the credit balance upon the Depreciation Fund Account will equal exactly the debit balance upon the Investment Account. Under this system it will be seen that the amounts retained for depreciation are withdrawn from the business, and thus at the end of the life of the asset, the investments can be realised, and will produce a sum of cash immediately available for the replacement of the expired asset. The debit balance upon the old asset account will be written off against the credit balance upon the Depreciation Fund Account. This method is a very good one to adopt where it is desired to provide the cash necessary for the purpose of replacement.

Insurance Policy System. Under the Depreciation Fund system there is always a risk that the investments may not realise cost price, and that thus the exact sum required may not be obtained; therefore, to obviate this, a policy is taken out with an insurance company under which the required sum to replace the asset is payable at the end of the period of the asset's estimated life. In this case, an amount equal to the amount of the annual premium is debited to Profit and Loss Account each year and credited to a Depreciation Fund Account, and the premium, when paid, is credited to cash and debited to a Policy Account. At the end of the term, the amount received under the policy is credited to the Policy Account, which account will show a credit balance which represents the interest allowed by the insurance company. This credit balance is transferred to the credit of the Depreciation Fund Account making the credit balance upon this account exactly equal to the amount received under the policy. If the old asset is now of no value, the debit balance upon the old asset account will be written off against the credit balance upon the Depreciation Fund Account.

Annuity System. This system is sometimes adopted

in cases where the amounts charged for depreciation are to be retained in the business, and interest upon the capital invested in the asset is to be taken into account. From tables a fixed amount to be written off for depreciation each year is ascertained, which sum, after taking credit for interest at an agreed rate upon the reducing balance of the asset, will write the asset down to nil at the end of the period of its estimated life. The annual charge for depreciation will be credited to the asset account and debited to Profit and Loss Account, whilst the interest, calculated upon the reducing balance, will be debited to the asset account and credited to Profit and Loss Account. The amount written off for depreciation is the same each year, but the interest taken credit for becomes less each year, and, therefore, the annual net charge (that is, depreciation less interest) grows heavier each year. The reason for this is, that the amounts set aside each year for depreciation are adding to the available working capital of the business, and as the business will be using these sums and be earning income therewith, the question of interest is taken into account. For example, in the case of a lease for a period of twenty years and costing (say) £10,000, in the first year, capital to the amount of £10,000 is locked up in this lease, but as the depreciation is provided each year, this capital is replaced, and, for instance, during the last year nearly £10,000 has been provided out of revenue—this amount forming additional working capital, of which the business has the use in the meantime. Therefore, the increasing charges for depreciation, caused by the diminishing interest taken into account, are compensated for by the earnings of the accumulations of depreciation which are increasing the working capital. This system is seldom used in practice, and the only items to which it is sometimes applied are leases, in which case the period of life is known exactly, and there is no question of additions.

RE-VALUATION. Under this system the assets are

re-valued each year, and this is the only satisfactory method to adopt with such assets as loose tools, harness, live stock, copyrights, and other assets of this nature, because it is almost impossible to fix rates of depreciation that will work out accurately, since these assets are constantly changing.

The Auditor's Duties as regards Depreciation. As has already been pointed out, it is impossible for an auditor to estimate the working lives of the assets of a business; consequently, he cannot estimate the amounts that are necessary to provide for depreciation, but he should see that this subject has been properly considered, and that correct principles have been applied. He should ascertain upon whose advice the amounts written off for depreciation have been fixed, that the working lives have been honestly estimated, and that the rates written off are sufficient to reduce the particular assets to nil by the end of such periods. If he finds that this question has been properly considered, he has no further concern, even though he may think it would be wise to write off larger amounts, for an auditor must appreciate that he has no expert or technical knowledge of such assets as plant and machinery, and that, therefore, he should accept the opinions and conclusions of those who have such knowledge. But, on the other hand, should it be palpable that sufficient depreciation is not being provided for, or he finds that this question has not been adequately and honestly considered, the rates and amounts having been fixed, either in a haphazard manner, or with a view to inflating the profits, then he should state definitely in his audit report that he is not satisfied that the provisions are sufficient. However, before taking this course, he should discuss the whole question fully with the management, hearing their views, and laying his before them; if, thereafter, he is still not satisfied, and the directors or partners refuse to alter the accounts, he should then report as stated above.

Reserves.

The word "reserve" has been used somewhat loosely in connection with accounts, with the result that misconceptions have arisen with regard thereto in the mind of the general public. Even in the accountancy profession, there is some difference of opinion in connection with this subject. The reason for this is that the term "reserve" has been used in widely different senses, and to describe very diverse states of affairs.

Reserves may be sub-divided under the following headings—

Specific Reserves | Reserve Funds
General Reserves | Sinking Funds
Secret Reserves

and it is proposed now to consider briefly each of these sub-divisions.

SPECIFIC RESERVES. A specific reserve represents a sum *charged* against profits to provide for a known contingency, the exact amount of which, however, cannot be ascertained, and has, therefore, to be estimated, such as reserves for bad debts, discounts, depreciation, future repairs and renewals, disputed claims, etc. In the case of reserves for bad debts, discounts and depreciation, it is known that the assets are subject to loss under these heads, but the exact amount of such loss has to be estimated and provided for by means of specific reserves. In these cases, the reserve should be charged to Profit and Loss Account, and deducted from the corresponding asset in the Balance Sheet. In the case of specific reserves for accruing repairs and renewals, and for disputed claims, it is known that a liability will arise, but the exact amount thereof cannot be ascertained, and again, therefore, the amount has to be estimated and debited to Profit and Loss Account. In this latter case the amount provided will appear upon the debit side of the Balance Sheet, and is in effect merely a liability that has had to be estimated.

Specific reserves are a charge against revenue, and must be provided for whether the Profit and Loss Account shows a profit or a loss. In fact, if a loss, it is more important than ever that ample provision should be made under these heads, in order that it may be seen exactly to what extent the capital of the concern has been lost.

In the above circumstances, it is thought that the term "reserve" has been badly used, and it would be better to use some other term, such as "provision;" but if the word "reserve" is used, it should always be followed with explanatory words, such as "for bad debts," "in respect of disputed claims," so that the exact circumstances may be clearly appreciated.

General Reserves. A general reserve represents sums set aside *out of profits,* to provide against unknown future contingencies, to increase the working capital, to equalise dividends, or merely to strengthen the financial position of the concern. A general reserve pre-supposes a profit and is *an appropriation of profits.* In other words, a general reserve represents profits retained in the business, which are ear-marked for any of the above purposes, and, in fact, these reserves might well be described in the Balance Sheet as "undistributed profits." A true profit must be represented by a corresponding surplus of assets over capital and liabilities, and, therefore, as a general reserve is created by retaining part of such profits, it must, in its turn, be represented by a corresponding surplus of assets. In fact, it is of the essence of a general reserve that it should consist of such a surplus of assets. The credit balance upon the General Reserve Account, which appears upon the debit side of the Balance Sheet, represents merely the gauge which measures the amount of the surplus of assets that are withheld from distribution to the proprietors of the business. The continued existence of the reserve is absolutely dependent upon the continued existence of the corresponding surplus of assets, so that if, for example, in the succeeding year the business makes

a loss in trading, equal to or exceeding the amount of the general reserve set aside out of the previous year's profits, then such reserve has automatically disappeared, as the surplus of assets has disappeared by reason of the subsequent loss. In these circumstances, therefore, the credit balance upon the General Reserve Account should be written off against the debit balance upon the Profit and Loss Account.

As a general reserve represents a surplus of assets over capital and liabilities, it will be appreciated that its existence depends upon the valuation of the assets, for if the assets have been over-valued, as for example, by insufficient provisions for bad debts and depreciation, then to the extent of such over-valuation of assets the surplus is non-existent. In the same way, the over-valuation of other assets has the effect of inflating the general reserves, and to the extent of the excess the reserve shown upon the Balance Sheet will be absolutely fictitious, and non-existent.

Reserve Funds. A reserve fund is the same as a general reserve, except that the surplus of assets representing the reserve is invested outside the business. These investments should be first class or "gilt edged" securities. This definition is not accepted by all the authorities, but it is suggested that the use of the word "fund" conveys to the general public that there is a distinct fund representing the reserve, that can be converted into cash whenever required.

A reserve fund is created by debiting Profit and Loss Account, and crediting a Reserve Fund Account, and at the same time an equal amount of cash is withdrawn and invested. These investments should be separately stated in the Balance Sheet, and should be described as being held on account of the reserve fund.

Investment of Surplus of Assets Representing General Reserve. Considerable discussion has taken place from time to time as to whether the surplus of assets

representing a general reserve should be invariably invested outside the business, but this is a matter of business policy which is entirely in the hands of the proprietors of the concern. If the object with which the reserve has been created is to provide additional working capital, for which very good use can be found in the business, then obviously the surplus of assets must be left in the business. In many cases this is a very wise course to adopt, as additional capital becomes available with which to extend the business, and upon which no interest is payable. In fact, most large and successful concerns have been built up from small beginnings by withholding profits, and thus providing the additional capital which, of necessity, is required by an increasing and expanding business. Therefore, it will be seen that this is a question with which an auditor has no concern, and that accountants cannot dictate the use that the proprietors of a business shall make of the funds of their business.

On the other hand, if a reserve is created with a view to providing the funds with which to meet unknown contingencies and liabilities that may suddenly arise in the future, then it is wise to invest the surplus outside the business, so that it may be in a form that is readily realisable into cash. Otherwise, the surplus assets will be used as additional working capital, and when the emergency arises, it may be found that these funds are locked up in such assets as stock, book debts, or plant and machinery, which cannot be immediately converted into cash without seriously disturbing the business.

In order to draw a distinction between these two positions which theoretically are the same, but which from a practical point of view are different, it is suggested that where the surplus assets representing a reserve are left in the business, the term " general reserve " should be used, but where the surplus is invested outside the business, the term " reserve fund " should be adopted.

The investment of a surplus representing a reserve

outside the business does not and cannot fix the existence of such reserve, which is absolutely dependent upon the continued existence of a surplus of the whole of the assets (including the ear-marked investments) over the capital and liabilities; if, subsequently, losses are incurred, the surplus is thereby automatically reduced, and, therefore, the reserve to this extent is also reduced, even though the investments may be still in existence. If a loss equal to the amount of the reserve fund is incurred, the reserve disappears entirely, and the credit balance thereon should be written off against the loss; the investments are then part of the general assets of the concern, and are required to provide for the liabilities and capital. It is absolutely impossible permanently to fix the amount of a surplus, which must of necessity increase or decrease from time to time, according to the fortunes of the business.

SINKING FUNDS. A sinking fund is very similar to a reserve fund, except that it is created for the definite purpose of redeeming a liability. Profits are appropriated and credited to a Sinking Fund Account, and at the same time corresponding amounts are invested outside the business. The interest earned by the investments should be credited to the Sinking Fund Account and re-invested. The term "sinking fund" is also used where provision is made for the replacement of a wasting asset, but, in these circumstances, "depreciation fund" is a better term. A depreciation fund, as has already been described in the earlier part of this chapter, is created in an exactly similar manner.

In the case of a sinking fund created to redeem a liability, the periodical debits to Profit and Loss Account represent appropriations of profits, and, after the liability has been paid off, a credit balance is left upon the Sinking Fund Account, which then represents a general reserve accumulated out of divisible profits. For example, suppose the case of a company having a debenture debt of £10,000, repayable at the end of ten years, and it is decided to

provide for the repayment of the debt by means of a sinking fund. At the commencement of the period the Balance Sheet would be as follows—

(1) BALANCE SHEET

	£		£
Capital	15,000	Assets	25,000
Debentures	10,000		
	£25,000		£25,000

At the end of the period, and before the repayment of the debentures, the Balance Sheet will be as follows—

(2) BALANCE SHEET

	£		£
Capital	15,000	Assets	25,000
Debentures	10,000	Sinking Fund Investments	10,000
Sinking Fund . . .	10,000		
	£35,000		£35,000

If now the sinking fund investments realise their cost exactly, the £10,000 produced will be used to pay off the debentures, and the Balance Sheet will be as follows—

(3) BALANCE SHEET

	£		£
Capital	15,000	Assets	25,000
General Reserve . .	10,000		
	£25,000		£25,000

The above should be compared with Balance Sheet No. 1, when it will be seen that the positions are identical, except that the liability to outside debenture holders has been replaced by the general reserve, which represents undrawn profits. If no sinking fund had been created, when the debentures became due, the company would have had to re-borrow money or sell part of its general assets, instead of which it has voluntarily held back profits, and in this way has accumulated the necessary funds with which to pay off the liability. Originally, the shareholders had £15,000 only invested in the business, but now they have £25,000 invested, the further £10,000

representing divisible profits that have been left in the business, and which have been used to pay off a capital liability.

A sinking or depreciation fund created to replace a wasting asset is built up in the same way, but, upon completion, the debit balance upon the account of the old and now expired asset is written off against the credit balance upon the Sinking or Depreciation Fund Account, which latter account thus disappears, and the investments provide the cash with which to purchase the new asset. In this case, the annual debits to Profit and Loss Account are a *charge* against profits, as they represent the provision for the depreciation of the wasting asset.

SECRET RESERVES. A secret reserve is a reserve that is not disclosed in the Balance Sheet, so that the financial position is, in fact, better than appears from the Balance Sheet. Secret reserves are created for the purpose of equalising dividends, or to provide a fund out of which heavy losses can be met, without disclosing the fact to the shareholders and general public; also, in some cases, to avoid disclosing information to trade rivals.

Secret reserves are created by writing down assets, such as stock, book debts, plant and machinery, and premises, below their true value, by making excessive provisions for outstanding liabilities, and by charging capital items, such as additions to plant and machinery, to Profit and Loss Account.

The Auditor's Position as regards Reserves. In the case of specific reserves, the auditor must enquire into these most carefully, with a view to satisfying himself that the provisions made are sufficient. His duties as regards these reserves, such as bad debts, depreciation and outstanding claims, have been discussed already.

The auditor is not concerned with the creation of general reserves, except that he must see that the accounts have been properly taken, and do show a *bonâ fide* surplus, and that the reserves are clearly and properly stated in the

Balance Sheet. If the reserves are fictitious, owing, for example, to the over-valuation of stock, or the insufficient provision for depreciation and bad debts, then the auditor must deal with the whole question in his audit report. If the accounts are in order and disclose profits, an auditor cannot insist upon the creation of general reserves, as that is a matter entirely outside his province, except in the case of a company when the Articles of Association specially provide for the creation of such reserves; however, in practice, auditors are often asked to advise as regards these matters. Again, an auditor cannot insist upon the surplus assets representing a general reserve being invested outside the business, his duty being confined to seeing that the true position of affairs is disclosed in the accounts. In the same way, he cannot demand that a sinking fund be created to redeem a liability, such as debentures, except in the case of a company, when it is so provided in the Articles of Association, or the terms of issue.

The auditor's position with reference to secret reserves is one of some little difficulty. Theoretically, there can be no question that secret reserves cannot be justified, and it may be said that in such circumstances the auditor cannot report that the Balance Sheet shows a true and correct view of the state of the affairs of the concern. But, in the case of large public companies, these reserves are of such considerable practical value that they are adopted extensively, and in practice, auditors do not invariably refer to such reserves in their audit reports.

In the case of partnerships, secret reserves are not common, and, if in existence, all the partners should be made aware of the fact. In the case of private companies, where the number of shareholders is small, and the accounts are not in the hands of the public, secret reserves should not be necessary. In such circumstances, all the shareholders are entitled to see the full position of affairs, and, therefore, if secret reserves, to any material extent, have been created by the directors, the auditor should make

this fact clear in his audit report. But the circumstances with large public companies are entirely different, for the accounts are published, and are thus available for the general public, the customers, creditors and competitors of the company, as well as the shareholders, and, therefore, it is a matter of very great importance to consider the effect that information disclosed in the accounts may have upon the credit of the concern. Such companies, therefore, often create these secret reserves, so that they may be able to meet emergencies and heavy losses without disclosing to the whole world that they have met with such reverses. This is in the interests of the shareholders as a body, as in this way the public credit of the concern is maintained.

On the other hand, secret reserves might be used by unscrupulous directors for most improper purposes, for example, to cover up losses upon *ultra vires* transactions, or for the purpose of private speculation in the shares of the company, for the market value of its shares may be influenced by making the results shown by the accounts fluctuate improperly by the manipulation of secret reserves created in the past. Therefore, it is most important that an auditor should enquire most carefully into the whole question of the secret reserves, with a view to ascertaining that they are necessary in the interests of the company, and that they are being used for *bonâ fide* purposes only. If he is satisfied that this is the case, he may safely pass the matter without reference in his report, though in these circumstances some auditors make a general statement in their audit report that the value of the assets is understated, thereby disclosing the fact that there is a secret reserve, but not showing its amount. If, however, the auditor is not absolutely satisfied as to the *bonâ fides* of these transactions, he should without fail deal with the matter fully in his report to the shareholders.

CHAPTER VII

SECTIONS OF THE COMPANIES (CONSOLIDATION) ACT, 1908, PARTICULARLY AFFECTING AUDITORS

It is necessary that an auditor should be familiar with practically the whole of the provisions of the Companies Acts, 1908 to 1917, but in the space available it is only possible to deal briefly with the few sections of the 1908 Act that are of particular importance from an auditor's point of view.

Appointment and Remuneration of Auditors.

The appointment and remuneration of auditors are provided for in Section 112 of the Companies (Consolidation) Act, 1908, as follows—

> "Every company shall at each annual general meeting appoint an auditor or auditors to hold office until the next annual general meeting." (*Sec.* 112 (1).)

It will be observed that the above Sub-section refers to "every company" registered under this Act, so that private companies are not exempted, as is often thought. The appointment is made by the shareholders as a body, and the auditor is, therefore, acting as their agent to audit the accounts of the directors, who themselves are merely agents of the shareholders, on whose behalf and for whose benefit the directors carry on the business. This fact must be thoroughly appreciated and borne in mind by an auditor, for though, in the course of his work he is constantly brought into contact with the directors, who conduct the business, yet he is not acting for them at all. He is appointed to act as a check upon the directors, and to ensure on behalf of the shareholders, who are the proprietors of the business, that the directors carry on the undertaking honestly for the benefit of the shareholders, and render to them true and correct accounts.

> "If an appointment of auditors is not made at an annual general meeting, the Board of Trade may, on the application of any member of the company, appoint an auditor of the company for the current year, and fix the remuneration to be paid to him by the company for his services." (*Sec.* 112 (2).)

In this case, although the Board of Trade makes the appointment, the auditor acts as the agent of the shareholders in exactly the same way as if he had been appointed at the annual general meeting, and he does not act specially on behalf of the member who applied to the Board of Trade, but on behalf of the whole body of shareholders.

> "A director or officer of the company shall not be capable of being appointed auditor of the company." (*Sec.* 112 (3).)

In this way it is provided that the auditor shall be quite independent, as would not be the case if, for example, the secretary of the company were also appointed auditor. As secretary, he would be a servant of the directors, subject to their authority; but it is essential that an auditor should be absolutely independent of the board of directors, and, therefore, such an appointment is prohibited by the Act. In practice, it is not uncommon to find one partner in a firm of accountants acting as a director or secretary of a company, and another partner acting as auditor, and although the strict letter of the Act does not forbid this, yet it is undoubtedly contrary to the spirit of this Subsection, and such appointments are certainly not advisable. If serious questions arose between the directors and the auditor, the position of the individual partners of the firm would be one of very great difficulty, as there would arise directly conflicting interests. The position of the auditor, therefore, would not be one of disinterested independence, as it always should be.

> "A person, other than a retiring auditor, shall not be capable of being appointed auditor at an annual general meeting unless notice of an intention to nominate that

person to the office of auditor has been given by a shareholder to the company not less than fourteen days before the annual general meeting, and the company shall send a copy of any such notice to the retiring auditor, and shall give notice thereof to the shareholders, either by advertisement or in any other mode allowed by the Articles, not less than seven days before the annual general meeting—

"Provided that if, after notice of the intention to nominate an auditor has been so given, an annual general meeting is called for a date fourteen days or less after the notice has been given, the notice, though not given within the time required by this provision, shall be deemed to have been properly given for the purposes thereof, and the notice to be sent or given by the company may, instead of being sent or given within the time required by this provision, be sent or given at the same time as the notice of the annual general meeting." (*Sec.* 112 (4).)

In the past it was found that conscientious auditors who carried out their duties properly, and, in consequence, occasionally came into conflict with the directors, were not re-elected at the annual general meeting, the directors nominating someone else for the appointment, without giving any notice beforehand to anyone. Therefore, these provisions were introduced by the Act of 1907, so that no person, other than the retiring auditor, can be appointed unless due notice has been given both to the shareholders and to the retiring auditor, who thus has an opportunity of laying his case before the shareholders. The second part of this Sub-section provides, that a notice of intention to nominate an auditor cannot be frustrated by the simple expedient of immediately summoning the annual general meeting, and fixing the date less than fourteen days from the date of the receipt of the notice.

"The first auditors of the company may be appointed by the directors before the statutory meeting, and if so

appointed shall hold office until the first annual general meeting, unless previously removed by a resolution of the shareholders in general meeting, in which case the shareholders at that meeting may appoint auditors." (*Sec.* 112 (5).)

From this clause it will be seen that the directors may appoint the first auditor prior to the statutory meeting, but even in this case the shareholders have the power to remove such auditor and appoint another in his place, should they desire it. The directors, when making the first appointment, are merely acting as agents for the shareholders, who have not yet met as a body, and the auditor, though appointed by the directors, acts for the shareholders in exactly the same way as if he were appointed direct by the shareholders.

"The directors may fill any casual vacancy in the office of auditor, but while any such vacancy continues, the surviving or continuing auditor or auditors, if any, may act." (*Sec.* 112 (6).)

In this case, again, the directors act for the shareholders, and appoint an auditor to fill the casual vacancy, but when appointed, the auditor is, as in all cases, the agent of the shareholders. This Sub-section does not mean that the directors themselves may act as auditors during the vacancy, as is sometimes thought by students, but that they may appoint an auditor, who must not be a director or officer of the company.

"The remuneration of the auditors of a company shall be fixed by the company in general meeting, except that the remuneration of any auditors appointed before the statutory meeting, or to fill any casual vacancy, may be fixed by the directors." (*Sec* 112 (7).)

The remuneration of the auditors, in the same way as their appointment, rests entirely with the shareholders, except where, as a mere matter of convenience, the directors act for the shareholders in the case of the appointment prior to the statutory meeting, and where a casual vacancy

occurs, and even in these latter circumstances, the appointment made or remuneration fixed by the directors, only holds until the next meeting of the shareholders, when they may refuse to re-appoint the nominee of the directors.

Powers and Duties of Auditors.

The powers and duties of auditors are defined by Section 113 of the Companies (Consolidation) Act, 1908, the terms of which are of the utmost importance. Sub-section (1) reads as follows—

> " Every auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the company, and shall be entitled to require from the directors and officers of the company such information and explanations as may be necessary for the performance of the duties of the auditors." (*Sec.* 113 (1).)

This Sub-section definitely gives the auditor the right of access to the books, accounts and vouchers of the company at all times, and " books " will include all statistical and memorandum books, such as minute books, cost books, stock books, share ledgers, etc. Further, " vouchers " will include all documentary evidence that the auditor may require, such as contracts, correspondence, invoices, etc. In addition to his right of access to the books, etc., the auditor is entitled to require from the directors and officers of the company information and explanations upon any points ; therefore, it will be seen that he is not confined to the books, but where the books and vouchers are not clear, he can call for explanations. The following Sub-section provides that if information is withheld, the auditor must report to the shareholders that he has not obtained all the information and explanations that he has required. The auditor's powers in this direction are very complete and strong, and are carefully defined in the Act.

> " The auditors shall make a report to the shareholders on the accounts examined by them, and on every Balance

Sheet laid before the company in general meeting during their tenure of office, and the report shall state—

(*a*) Whether or not they have obtained all the information and explanations they have required; and

(*b*) Whether, in their opinion, the Balance Sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of their information and the explanations given to them, and as shown by the books of the company." (*Sec.* 113 (2).)

It will be noted that the auditors have to make a report upon every Balance Sheet submitted to the shareholders in general meeting during their tenure of office, and that such report is addressed to the shareholders, and not to the directors. If the auditor is not satisfied upon any points, or there is any information that, in his opinion, should be placed before the shareholders, he must qualify his report accordingly, and make any such matters clear therein. It is the duty of the directors to prepare the accounts, and the auditor cannot alter such accounts in any way; if dissatisfied upon any point, his duty is confined to dealing with the matter in his report, and thus laying the true facts before the shareholders. In the same way, if the system of book-keeping is bad, the auditor cannot insist upon alterations, but if it is so bad that reliable accounts cannot be prepared, then, in such circumstances, he should report to this effect to the shareholders. However, as a rule, directors appreciate and value the advice of the auditor on such matters.

"The Balance Sheet shall be signed on behalf of the board by two of the directors of the company, or if there is only one director, by that director, and the auditor's report shall be attached to the Balance Sheet, or there shall be inserted at the foot of the Balance Sheet a reference to the report, and the report shall be read before the company in general meeting and shall be open

to inspection by any shareholder. Any shareholder shall be entitled to be furnished with a copy of the Balance Sheet and auditor's report at a charge not exceeding sixpence for every hundred words." (*Sec.* 112 (3).)

The Balance Sheet must be signed by the directors, but it is not the auditor's duty to see that this is done. The auditor's report must be either attached to the Balance Sheet, in which case it generally appears at the foot thereof, or it may be a separate document, but in this event at the foot of the Balance Sheet there must appear a reference to the report. It is the directors' duty to insert this note, for which no special wording is necessary, but the following is a good form—

The report to the shareholders of Messrs............ the Company's auditors, on the above Balance Sheet, which is dated the..........day of..............19.., will be read at the meeting, and is open to inspection.

The directors have the right to decide whether the auditor's report shall be attached to the published Balance Sheet or not, but the intention of the Section appears to be that the report should be looked upon as a confidential one from the auditor to the shareholders, and, therefore, the better course is to make it a separate document, which is not published broadcast, as the Balance Sheet often is. The report referred to on the Balance Sheet has to be read at the shareholders' meeting, is open to inspection, and any shareholder is entitled to demand a copy, so that there is no risk of the information contained in the report being held back from the shareholders. There is no doubt that, if the report is not published with the Balance Sheet, the auditor is given a much freer hand, as he may have no hesitation in reporting fully to the shareholders any matters which, in his opinion, should be made clear to them. On the other hand, if the report is published with the Balance Sheet, and thus reaches the hands of the general public, the creditors, customers and competitors

of the business ; should the auditor have to report adversely upon any matters, the credit of the concern might be seriously affected. Therefore, the report should be made accessible to shareholders only, so that the auditor may be in no way hampered by these other considerations.

It is most important that the report should identify very clearly the particular Balance Sheet to which it refers, so that there may be no room for after-dispute or confusion, and no danger that by mistake or otherwise the Balance Sheet submitted to the shareholders, though bearing the proper date should not be the one actually referred to in the report. If the report is a separate document, the auditors should initial the particular Balance Sheet they are referring to, and should state this fact in the report, and in all cases they should keep a copy of the Balance Sheet sent, and place a memorandum of identity thereon, so that if the question arises, they may be able to testify with certainty as to the matter. The better and safer course, however, is to write the report at the foot of the audited Balance Sheet, so that, in this way, the two documents are made inseparable. This course does not prevent the directors from sending to the shareholders copies of such Balance Sheet without the report, but with merely a reference thereto. The following is the form of report recommended by the Council of the Institute of Chartered Accountants in England and Wales—

REPORT OF THE AUDITORS TO THE SHAREHOLDERS OF..........LIMITED.

We have audited the Balance Sheet of the...........Limited, dated the........day of.......and (here identify it as : " above set forth," or " within contained," or " a copy of which is annexed hereto and initialled by us," or, " a copy of which has been initialled by us ").

We have obtained all the information and explanations we have required.

In our opinion such Balance Sheet is properly drawn

up so as to exhibit a true and correct view of the state of the company's affairs according to the best of our information and the explanations given us and as shown by the books of the company.

"If any copy of a Balance Sheet which has not been signed as required by this Section is issued, circulated or published, or if any copy of a Balance Sheet is issued, circulated, or published without either having a copy of the auditor's report attached thereto or containing such reference to that report as is required by this Section, the company, and every director, manager, secretary, or other officer of the company who is knowingly a party to the default, shall on conviction be liable to a fine not exceeding fifty pounds." (*Sec.* 113 (4).)

From this Sub-section it will be seen that there is a heavy penalty if the terms of this Section are not carried out.

"In the case of a banking company registered after the fifteenth day of August, eighteen hundred and seventy-nine—

(*a*) If the company has branch banks beyond the limits of Europe, it shall be sufficient if the auditor is allowed access to such copies of and extracts from the books and accounts of any such branch as have been transmitted to the head office of the company in the United Kingdom; and

(*b*) the Balance Sheet must be signed by the secretary or manager (if any) and where there are more than three directors of the company by at least three of those directors, and when there are not more than three directors by all the directors." (*Sec.* 113 (5).)

This Sub-section refers only to banking companies.

"Holders of preference shares and debentures of a company shall have the same right to receive and inspect the Balance Sheets of the company and the reports of the auditors and other reports as is possessed by the holders of ordinary shares in the company." (*Sec.* 114 (1).)

> "This section shall not apply to a *private company*, nor to a company registered before the first day of July nineteen hundred and eight." (*Sec.* 114 (2).)

This was an important innovation introduced by the Companies Act, 1907, by which preference shareholders and debenture holders were given the right to receive and inspect the Balance Sheets of the company, and the auditors' reports, except in the case of private companies and those registered before the 1907 Act came into force.

Annual List and Summary.

Section 26 of the Companies (Consolidation) Act, 1908, provides that every company shall once at least in every year make a list of all the members of the company, such list containing various particulars as regards the share capital of the company, the amount called up and paid on each share, the total amount of calls unpaid, and various other particulars. This annual list and summary must be contained in a separate part of the register of members, and a copy, signed by the manager or secretary, must be forwarded to the Registrar of Companies.

Sub-section 3 of this Section provides as follows—

> "The summary must also (except where the company is a private company) include a statement, made up to such date as may be specified in the statement, in the form of a Balance Sheet, audited by the company's auditors, and containing a summary of its share capital, its liabilities, and its assets, giving such particulars as will disclose the genéral nature of those liabilities and assets, and how the values of the fixed assets have been arrived at, but the Balance Sheet need not include a statement of profit and loss."

In many cases the last audited Balance Sheet of the company is filed to comply with this Sub-section, and provided that it gives the required information, this will be sufficient, and the auditors will not have specially to

audit or certify the same. But, if the audited Balance Sheet is condensed, or a special one is prepared for filing, then the auditors will have to audit it and certify that they have done so. There is no special form of certificate provided for in the Act, and a memorandum will be sufficient signed by the auditors to the effect that they have audited the statement in the form of a Balance Sheet, and that to the best of their information it has been properly prepared in accordance with the requirements of the Section.

As regards the fixed assets, the statement must show how the values of the same have been arrived at, that is to say, these assets should in each case be described as being "at cost," "at cost less depreciation," or "as valued by the directors," etc. In this connection, the case of *Galloway* v. *Schill, Seebohm & Co., Ltd.*, is of importance. In the statement in the form of a Balance Sheet, this company included all its fixed assets in one total, thus: "Goodwill, Trade Marks, Machinery, Furniture and Fixtures £100,007 16s. 5d.," stating that the Goodwill and Trade Marks were valued at the "sum at which they were taken over by the Company," and that the Machinery, Furniture and Fixtures were valued "at cost less depreciation." It was held that this Balance Sheet did not comply with the requirements of the Section, because it stated that different parts of the fixed assets had been valued in different ways and did not state the separate values of those parts. Further, it was held that the Balance Sheet ought to state the separate values of the tangible and intangible fixed assets.

The Section provides that "the Balance Sheet need not include a statement of profit and loss"; therefore, it is usual not to include the balance on Profit and Loss Account, but to set out only the assets and liabilities as required by the Section, and then to total the two sides. It is the duty of the directors to prepare this statement and to submit it to the auditors for the purposes of audit.

The Statutory Meeting and Report.

Section 65 of the Companies (Consolidation) Act, 1908, provides that every company shall

> " not less than one month nor more than three months from the date at which the company is entitled to commence business, hold a general meeting of the members of the company, which shall be called the statutory meeting."

The directors shall, at least seven days before the day of the meeting, forward a report, called the statutory report, to every member of the company, and this report has to be certified by the directors, and a copy thereof has to be filed with the Registrar of Companies. But the provisions as to forwarding and filing the statutory report do not apply in the case of private companies.

The provisions of Sub-section 3 of Section 65 are as follows—

> " The statutory report shall be certified by not less than two directors of the company, or, where there are less than two directors, by the sole director and manager, and shall state—
>
> " (*a*) The total number of shares allotted, distinguishing shares allotted as fully or partly paid up otherwise than in cash, and stating in the case of shares partly paid up the extent to which they are so paid up, and in either case the consideration for which they have been allotted;
>
> " (*b*) the total amount of cash received by the company in respect of all the shares allotted, distinguished as aforesaid;
>
> " (*c*) an abstract of the receipts of the company on account of its capital, whether from shares or debentures, and of the payments made thereout, up to a date within seven days of the date of the report, exhibiting under distinctive headings the receipts of the company from shares and debentures and other

sources, the payments made thereout, and particulars concerning the balance remaining in hand, and an account or estimate of the preliminary expenses of the company;

"(*d*) the names, addresses, and descriptions of the directors, auditors (if any), managers (if any), and secretary of the company; and

"(*e*) the particulars of any contract, the modification of which is to be submitted to the meeting for its approval together with the particulars of the modification or proposed modification."

Certain parts of the statutory report have to be certified as correct by the auditors, if any have been appointed prior to the statutory meeting, Sub-section 4 providing—

"The statutory report shall, so far as it relates to the shares allotted by the company, and to the cash received in respect of such shares, and to the receipts and payments of the company on capital account, be certified as correct by the auditors, if any, of the company."

This will necessitate a complete audit of the share books of the company—which is described in detail in Chapter VIII—and also the complete vouching and checking of the Cash Book, it being seen that the Capital Receipts and Payments Account, contained in the report, is a correct summary. As this summary has to show particulars concerning the balance remaining in hand, the total of any revenue receipts and payments must be included on each side, so that the balance of cash remaining is shown. The capital receipts and payments must be fully described, but no details need be given as to the revenue items. Upon completion, the auditor will have to sign his certificate which is as follows—

I hereby certify that so much of this report as relates to the shares allotted by the company and to the cash received in respect of such shares and to the receipts and payments of the company on capital account is correct.

Underwriting Commissions and Commissions on Placing Shares.

Section 89 of the Companies (Consolidation) Act, 1908, gives a company power to pay underwriting commissions, and commissions on placing or procuring subscriptions for shares, provided that the payment of such commission is authorised by the Articles, and the commission paid, or agreed to be paid, is disclosed in the prospectus, or statement in lieu of prospectus, or any circular or notice inviting subscriptions for shares, and that the amount paid does not exceed the amount or rate authorised. "Underwriting shares" means that, upon an issue of shares to the public, certain persons enter into contracts with the company, that in the event of the public not subscribing for the whole of the issue, they, the underwriters, will subscribe for and take up the remaining shares. For example, suppose the case of a company making an issue of 100,000 £1 shares to the public, the whole issue being underwritten by various individuals who were entitled to an underwriting commission of 5 per cent. upon the shares underwritten by each—if the public applied for, say, 60,000 shares, the underwriters would have to take up the remaining 40,000 shares between them *pro rata*. The commission paid to them is for taking this risk, and it is payable whether they actually have to take up shares or not. The auditors must see that any underwriting commission is properly authorised by the Articles, and has been disclosed in the prospectus; they must also inspect the underwriting contract with each underwriter, and see that the underwriters take up the remaining shares if the issue is under-subscribed. Commissions for placing shares are paid to persons who introduce subscribers, in which case the person claiming the commission should initial or mark the application letter of the subscriber, and the auditors should examine the marked application letters and thus check the commission payable. Companies have always been entitled to pay a brokerage upon shares,

that is, an amount payable per share to stockbrokers and agents whose clients subscribe for shares. Such brokerages should only be paid if the application letters bear the brokers' stamp, and the auditor must, therefore, examine the stamped application forms. These payments of brokerage are not subject to the provisions of Section 89.

> "Where a company has paid any sums by way of commission in respect of any shares or debentures, or allowed any sums by way of discount in respect of any debentures, the total amount so paid or allowed, or so much thereof as has not been written off, shall be stated in every Balance Sheet of the company until the whole amount thereof has been written off." (*Sec.* 90.)

This Section provides that if any commissions in respect of shares or debentures are paid, and the total amount is not written off to Profit and Loss Account at once, but is spread over a period, the amount carried forward must be shown as a separate item in the Balance Sheet. The same applies if debentures are issued at a discount; the total amount of the discount must be treated in the same way. The auditors must see that the terms of this Section are complied with, and, therefore, these commissions or discounts upon debentures must not be included under the heading of preliminary expenses, but must be shown separately in the Balance Sheet.

Payment of Interest to Shareholders During Construction.

Section 91 of the Companies (Consolidation) Act, 1908, gives power, in certain circumstances, to pay interest to shareholders during construction, out of capital. The first part of the Section reads as follows—

> "Where any shares of a company are issued for the purpose of raising money to defray the expenses of the construction of any works or buildings or the provision of any plant which cannot be made profitable for a lengthened period, the company may pay interest on so

much of that share capital as is for the time being paid up for the period and subject to the conditions and restrictions in this section mentioned, and may charge the same to capital as part of the cost of construction of the work or building, or the provisions of plant."

Suppose, for example, the case of a company formed to carry on a manufacturing business, the factory having to be erected first. Until the factory is completed, the company cannot trade and can earn no profits, and, therefore, there can be no possibility of paying dividends to the shareholders upon their capital. In such circumstances, it is considered only fair that, upon the capital advanced by the shareholders specially for this purpose, they should receive interest during the period of construction, and this can be paid provided that the terms of this Section are complied with. The interest thus paid is paid out of capital and is debited to the Building Account, as part of the cost of construction. The provisions that have to be complied with are as follows—

(1) "No such payment shall be made unless the same is authorised by the Articles or by special resolution ;

(2) "No such payment, whether authorised by the Articles or by special resolution, shall be made without the previous sanction of the Board of Trade ;

(3) "Before sanctioning any such payment the Board of Trade may, at the expense of the company, appoint a person to enquire and report to them as to the circumstances of the case, and may, before making the appointment, require the company to give security for the payment of the costs of the enquiry ;

(4) "The payment shall be made only for such period as may be determined by the Board of Trade ; and such period shall in no case extend beyond the close of the half-year next after the half-year during which the works or buildings have been actually completed or the plant provided ;

(5) "The rate of interest shall in no case exceed four

per cent. per annum or such lower rate as may for the time being be prescribed by Order in Council;

(6) "The payment of the interest shall not operate as a reduction of the amount paid up on the shares in respect of which it is paid;

(7) "The accounts of the company shall show the share capital on which, and the rate at which, interest has been paid out of capital during the period to which the accounts relate."

It will be seen from the above that there are very stringent regulations governing this matter, and that such payments of interest out of capital are controlled by the Board of Trade.

In cases where interest is paid in this way, an auditor must see that all the provisions of Section 91 have been complied with.

Statutory Books.

Every company registered under the Companies Acts, 1908 to 1917, must keep the following books—

(1) Register of Members (Sec. 25 of the Companies (Consolidation) Act, 1908), in which must be entered the names, addresses, and occupations of all the members of the company, the shares held by each, the distinguishing numbers, and the amount paid or agreed to be considered as paid on such shares; also the dates at which each person was entered in the register, and the date at which any person ceased to be a member. Under Section 26 in a separate part of the Register of Members, the annual list of members and summary has to be entered.

The Register of Members is open to the inspection of any member gratis, and to the inspection of any other person on payment of a fee not exceeding 1s. for each inspection. (Sec. 30, Companies (Consolidation) Act, 1908.)

(2) Minute Book (Sec. 71, Companies (Consolidation) Act, 1908), in which must be entered minutes of all

proceedings at every meeting of the shareholders and directors or managers of the company.

(3) **Register of Directors** (Sec. 75, Companies (Consolidation) Act, 1908; and Companies (Particulars as to Directors) Act, 1917), in which must be entered the following particulars respecting each director: present Christian name or names and surname; any former Christian name or names and surname; nationality; nationality of origin (if other than the present nationality); usual residence; occupations. A copy of such register has to be sent to the Registrar of Companies.

(4) **Register of Mortgages and Charges** (Sec. 100, Companies (Consolidation) Act, 1908). In this register particulars of every mortgage or charge specifically affecting property of the company must be entered, giving, in each case, a short description of the property mortgaged or charged, the amount of the mortgage or charge, and (except in the case of securities to bearer) the names of the mortgagees or persons entitled thereto. The register is open to the inspection of any person on payment of a fee not exceeding 1s. for each inspection.

CHAPTER VIII

SPECIAL POINTS IN CONNECTION WITH THE AUDIT OF COMPANIES UNDER THE COMPANIES ACTS, 1908 TO 1917

THE principles of auditing apply to all audits, but in connection with companies under the Companies Acts, 1908 to 1917, there are some special points which must be dealt with here, as the audit of these companies forms such a preponderantly large proportion of the audit practices of accountants, that no book on auditing would be complete without some more or less detailed reference to the audit of these concerns.

Memorandum of Association.

Every company limited by shares must have a Memorandum of Association, stating—

(1) The name of the company, with "limited" as the last word in its name.

(2) The situation of the registered offices of the company.

(3) The objects of the company.

(4) That the liability of the members is limited.

(5) The amount of share capital with which the company proposes to be registered, and the division thereof into shares of a fixed amount.

The most important of these from an auditor's point of view is No. 3, for the objects clause must set out exactly the purposes for which the company is formed, and the nature of the business that it is intended to carry on, and a company has no power to enter into any transaction that does not come within the terms of its objects clause. This clause is always made as wide as possible, but an auditor must see that the company does not break the provisions thereof and enter into *ultra vires* transactions.

The terms of the Memorandum cannot be altered, except

by complying with certain provisions in the Act, and considerable restrictions are placed in the way of such alterations. Important ones, such as a reduction of capital, or alteration of the objects of the company, require the sanction of the Court; and shareholders, debenture holders and creditors, who may be affected by the alterations, are entitled to place their views before the Court.

The Memorandum of Association may be said to govern the external affairs of a company, and every clause is of interest and importance to all persons entering into business relations with a company.

Articles of Association.

A company need not have a special set of Articles, and the Companies (Consolidation) Act, 1908, contains a model set of Articles known as Table A, which govern all companies for which special Articles have not been drawn up. But, upon formation, a company may exclude the whole or parts of the provisions of Table A, and substitute therefor its own specially drawn Articles. An auditor must see whether Table A, or parts thereof, have been thus excluded, for he must be familiar with the exact regulations that govern the particular company.

The Articles of Association govern the internal affairs of the company, and an auditor must see that the terms thereof are complied with. The Articles can be altered at any time by a special resolution of the shareholders. The following are examples of matters that are governed by the terms of the Articles—

The rights of shareholders *inter se*.

Calls on shares.

The forfeiture of shares on account of the non-payment of calls.

Alterations of capital.

The appointment of a managing director.

The appointment of directors.

The powers and duties of directors.

The declaration of dividends.

The accounts and audit.

The borrowing powers.

The payments of underwriting commissions, and commissions on placing shares.

The payment of interest out of capital during construction.

Examination of Legal Documents Prior to the Commencement of the Audit of a Company.

Before commencing the audit of a company, an auditor should examine carefully the Memorandum and Articles of Association, and he should make notes in his audit note-book of all important provisions, with the terms of which he must be familiar while conducting his audit. In the same way he should examine the prospectus and the contract of sale (if any) with the vendors, and from the latter he will ascertain the purchase price, particulars of the assets that are being acquired, and the liabilities (if any) that are being taken over. It then must be seen that the opening Journal entries are correct and in accordance with the contract, and also that the various terms of the latter are carried out. In the case of a continuing company, the previous year's Balance Sheet and auditor's report should be examined.

Share Capital.

The share capital of a company is often divided into preference and ordinary shares, and the rights of the respective shareholders are governed by the terms of the Articles. The preference shares, as a rule, are entitled to a fixed dividend out of the profits, the surplus profits after the payment of the dividend on the preference shares belonging to the ordinary shareholders. It depends upon the terms of the Articles whether the preference shares also carry a preferential right as regards capital, that is to say, whether, in the event of liquidation, the preference shareholders are entitled to the return of their capital before

there is any return on the ordinary shares. The Articles must expressly provide that the preference shares are to be preferential as to capital, otherwise they rank equally with the ordinary shares in this respect The preference shareholders' rights to dividend may be either cumulative or non-cumulative; if cumulative, it means that in the event of there not being sufficient profits in any year to pay the preference dividend, such arrears have to be made up in any future years when the profits are sufficient, and thus there can be no dividend paid upon the ordinary until all such arrears upon the preference shares have been paid. If non-cumulative, the preference shareholders are entitled to a fixed dividend out of the profits of each year, and if such are insufficient, then there is no right to make up shortages out of the surplus profits of future years. All preference shares are cumulative, unless the Articles specially provide that they shall be non-cumulative.

Issue of Shares.

In the ordinary course, the first step in the raising of share capital is the issue of a prospectus inviting applications for shares, such prospectus being advertised in newspapers, and circulated through stockbrokers and others connected with or interested in the company. As a rule, applications for shares have to be sent in on special forms direct to the company's bankers, accompanied by a deposit, the banker sending the applicant a receipt therefor. These applications are numbered and entered in an Application and Allotment Book, and in due course are considered by the directors, who then allot shares to the applicants. If more shares have been applied for than are being issued according to the prospectus, the directors make a selection and refuse certain of the applications, notice of this fact being sent to the applicant by means of what is known as a "Letter of Regret," and at the same time the deposit paid is returned. In other

cases, where there is an over-subscription, the number of shares applied for by individual subscribers is reduced proportionately, and allotments made accordingly, the amount over-paid upon application, as a rule, being applied in reduction of the further amounts due in respect of the shares. The allotment is made by the directors passing a minute to this effect, and sending to each applicant an "Allotment Letter," notifying the number of shares allotted and the amount due on allotment. The balance due upon the shares either has to be paid up on certain dates specified in the prospectus, or is called up as and when the directors require the money—in which latter case a minute is passed by the board making the call, and notices are sent to all shareholders. In due course, when the share certificates have been made out for each shareholder, these are issued in exchange for the allotment letter and the banker's receipts for the instalments paid to date.

Audit of the Share Books upon an Issue of Shares.

The audit of the Share Books upon an issue of shares should be conducted as follows—

(1) Check the application letters with the Application and Allotment Book.

(2) Check the Share Cash Book with Pass Book.

(3) Check amounts received from subscribers from the Cash Book to the Application and Allotment Book.

(4) Check minutes of allotment with Application and Allotment Book.

(5) Check "letters of regret" or press copies thereof with Application and Allotment Book, and see that amounts paid on application are returned.

(6) Check the distinctive number given to each block of shares.

(7) Check the Application and Allotment Book to the Share Ledger, seeing that all details are entered correctly.

(8) See that the total shares issued do not exceed the total authorised capital according to the Memorandum.

(9) See that the minimum subscription upon which the company may proceed to allotment has been applied for.

(10) Vouch the opening Journal entries in the financial books.

(11) Check the balances on the Share Ledger to the schedule, seeing that the total agrees with the total number of shares issued.

(12) If shares have been issued for consideration other than cash, see the contracts and the minutes adopting them, and ascertain that such contracts have been filed with the Registrar of Companies.

(13) If the issue has been underwritten, see the contracts with the underwriters, and, if the issue is not fully subscribed, the directors' minutes allotting the balance of the shares to the underwriters. Underwriters, as a rule, have to sign applications for the number of shares they underwrite—if so, inspect these. Vouch the Journal entries.

(14) If placing commissions and brokerages are paid, check the amounts paid with stamped or marked application forms. Inspect the receipts from persons receiving such commissions and brokerages.

(15) As a rule, the auditors are requested to check and initial the share certificates before they are signed and sealed by the directors.

(16) Upon calls becoming payable, the detail amounts due will be entered in a Call Book, or in special columns in the Application and Allotment Book, and these entries will be checked in the same way as the allotment, that is, with the directors' minute, the Cash Book and Pass Book, and to the Share Ledger.

(17) If the share certificates have been issued, the returned allotment letters and bankers' receipts should be checked with the Share Ledger.

Transfer Audit.

An auditor must audit the share books upon an issue of shares, and when calls are made, in order that he may satisfy himself that the whole of the money due has been accounted for. In subsequent years, however, it is not part of his duty to carry out a transfer audit, all that is necessary being that the balances upon the Share Ledger should be checked on to a list of balances, it being seen that the total thereof agrees with the total issued capital. Auditors are often instructed to carry out transfer audits, but this is a matter of special arrangement, and one for which the auditor is entitled to a special fee. The procedure at a transfer audit should be as follows—

(1) When transfers are received, the transferor should be notified immediately, so that in this way fraudulent transfers may be detected. If this system is in force, check the duplicate copies of such notices to the Transfer Register, and enquire as to whether any objections have been received.

(2) Check transfers with the Transfer Register, seeing that transfers have been properly signed, witnessed and stamped, and check the distinctive numbers of the shares into the Register. Thereafter, cancel the transfer with the auditor's audit stamp.

(3) Verify the signatures of transferors with previous transfers or application letters.

(4) Check old certificates with transfers, and thereafter cancel the certificates.

(5) Check entries in Transfer Register to the credit of the transferor's account in Share Ledger, seeing that he has the shares, and checking the distinctive numbers.

(6) Check entries in Transfer Register to debit of transferee's account in Share Ledger.

(7) Check and initial new certificates, and if transferor has not sold the whole of his shares, check and initial balance certificates issued to him.

(8) At subsequent audits, see the directors' minute passing the transfers previously checked.

Transfer Fees.

Count the number of transfers, and see that the whole of the transfer fees has been accounted for.

Debentures.

Upon an issue of debentures, the allotment, etc., will be checked in exactly the same way as an allotment of shares. The auditor must see that the Articles give the directors power to borrow money in this way, and he should examine the directors' minute exercising that power. The actual debenture or trust deed should be examined, in order that the exact terms of the issue may be ascertained. It must further be seen that the charge given by the debentures upon the assets of the company is entered in the Register of Mortgages and Charges, in accordance with Section 100 of the Companies (Consolidation) Act, 1908, and that the necessary particulars have been filed with the Registrar of Companies.

The entries in the financial books should be checked, and if debentures are issued at a discount, the full nominal amount must be credited to the Debenture Account, as that is the actual amount of the liability that will have to be repaid, and the amount of the discount must be debited to a separate account. If this discount is written off to Profit and Loss Account over a period, the amount carried forward must be shown as a separate item in the Balance Sheet, to comply with the terms of Section 90 of the Companies (Consolidation) Act, 1908. The discount upon debentures should be written off to revenue as soon as possible, but, subject to the provisions of the Articles of the particular company, an auditor could raise no objection, if the discount were written off over the period of the debentures. Shares can never be issued at a discount,

but debentures can, subject to the provisions of the Articles of Association.

If debentures are issued at a premium, the nominal amount of the debentures again must be credited to the Debenture Account, and the amount of the premium must be credited to a Premium on Debentures Account. Shares may be issued at a premium, in which case the premium should be dealt with in exactly the same way. Premiums upon shares and debentures should be utilised as additional working capital, and, therefore, transferred to reserve, or used to write down preliminary expenses, goodwill, or any fixed assets ; but, on the other hand, unless there are express provisions in the Articles, there is nothing in the Companies Acts to prevent such premiums being credited to Profit and Loss Account. This latter is, however, an unsound course to adopt, as such premiums are not an ordinary trading profit, and, in effect, if such sums were credited to Profit and Loss Account, and thus made available for dividend, if a dividend were paid it would amount to a return to the shareholders as dividend of amounts which they themselves had subscribed. If premiums on shares or debentures were made available for dividend in this way, an auditor should see that the accounts made this fact quite clear.

If debentures are issued at par and repayable at the end of a period at a premium, then they should appear in the books and on the Balance Sheet at the nominal amount, with a note that they are repayable at a certain date at a premium. The premium is in the nature of a payment of deferred interest, and should be provided for out of revenue over the period of the debentures, as otherwise the whole amount of the premium will have to be charged to the Profit and Loss Account of the year in which the debentures are redeemed. If a sinking fund is being created to provide for the redemption of the debentures, then it should include the premium. To illustrate this, suppose the case of a company with debentures of £10,000

repayable at the end of ten years at a premium of 5 per cent., the Balance Sheet at the commencement of the period being as follows—

BALANCE SHEET

	£		£
Capital	15,000	Sundry Assets . . .	25,000
Debentures (repayable at the end of ten years at 105)	10,000		
	£25,000		£25,000

A sinking fund is created to provide £10,500, the amount required, and the Balance Sheet at the end of the period would be as follows—

BALANCE SHEET

	£		£
Capital	15,000	Sundry Assets . . .	25,000
Debentures	10,000	Investments on account of Sinking Fund . .	10,500
Sinking Fund . . .	10,500		
	£35,500		£35,500

The Debenture Account now should be credited with £500, the amount of the premium payable, this amount being debited to the Sinking Fund Account. If the investments realised cost, the exact sum required to pay off the debentures at the premium, would be produced, and, after such repayment, the Balance Sheet would be as follows—

BALANCE SHEET

	£		£
Capital	15,000	Sundry Assets . . .	25,000
Sinking Fund Account (now a general reserve of the company) . .	10,000		
	£25,000		£25,000

It will be seen that, although £10,500 has been provided over the period, only £10,000 remains upon the Sinking Fund Account after the repayment of the debentures.

The reason for this is, that the £500 premium is a charge against the profits in exactly the same way as is the interest paid upon the debentures, and would have had to be charged against revenue in any event, but the provision of the £10,000 is an appropriation of profits and is a voluntary act by which profits available for distribution have been retained in the business and used to pay off a capital liability, or, in other words, the shareholders have invested £10,000 of their profits in the concern instead of withdrawing the same, thus making the total amount owing to them by the business £25,000 instead of £15,000, the original capital.

Debentures Issued as Collateral Security.

Debentures often are issued to creditors of a company to secure loans and overdrafts. For example, suppose the case of a company borrowing £7,000 from its bankers, and, as security for the repayment of this sum, issuing £10,000 debentures as collateral security. In the Balance Sheet, the bank should be shown as creditors for the loan of £7,000, and against this item should appear a note "in respect of which £10,000 debentures have been issued as collateral security." The position is that the primary liability of the company to the bank is the loan of £7,000, and the debentures held by the bank are dormant, and no interest is paid thereon, but if the company defaulted, then the bank could take up the debentures and would rank as debenture holders for £10,000, being entitled to their proportion of the security given to the whole debenture issue. If a receiver were appointed for the debenture holders, who eventually paid 20s. in the £, the bank would receive £10,000, out of which it would retain the loan of £7,000, interest to date and costs, and return any surplus to the company.

An auditor should see the loan agreement (if any) and the directors' minute issuing these debentures for this purpose, and he must see that the position is shown

correctly in the Balance Sheet. He should also ascertain that these debentures have been entered in the Register of Mortgages and Charges, and enquire as to whether the necessary particulars have been filed with the Registrar of Companies.

Preliminary Expenses.

Upon the formation of a company there are various initial expenses in connection with the formation and the obtaining of the share capital, that are debited to a Preliminary Expenses Account. An auditor should refer to the contract with the vendors to see whether they have to bear the whole or any part of these expenses, and, if so, he must see that the company does not bear any expenses that are payable by the vendors.

The auditor should carefully examine and vouch the items debited to this account, and thus satisfy himself that they are a proper charge to Preliminary Expenses Account. Under this heading will be included the following—

LEGAL CHARGES in connection with the preparation of the Memorandum and Articles of Association, the prospectus and the contracts with the vendors, and these will be vouched by the production of the solicitors' receipted bill of costs.

COSTS OF PRINTING the Memorandum and Articles of Association, and the prospectus, which will be vouched by the production of the printers' receipted bill of costs.

COSTS OF ADVERTISING the prospectus, which will be vouched with the receipts from the newspapers, or, if done through an agent, with his receipted account.

STAMP DUTIES payable upon registration, which probably will be paid by the solicitors, and will, therefore, appear in their bill of costs. The amount can be verified by an examination of the certificate of incorporation, upon which the duties paid are stated.

REPORTS FROM ENGINEERS, ACCOUNTANTS, ETC., for

prospectus purposes, which will be vouched with the receipted bills of costs.

The preliminary expenses should appear as a separate item in the Balance Sheet, and in order to comply with Section 90 of the Companies (Consolidation) Act, 1908, must not include commissions paid for underwriting or placing shares, or discounts upon debentures. The debit balance upon Preliminary Expenses Account should be written off to revenue over a short period of years, generally three to five years, but there is nothing in the Companies Acts to compel this, though there may be provisions to this effect in the Articles.

Profits Prior to the Date of Incorporation.

When a company is formed to purchase and take over an existing business, the contract often provides that the purchase is to be completed upon the basis of the figures as at a certain agreed date, such date being prior to the actual incorporation of the new company, one of the terms of the contract being that the new company shall take the profits as from the agreed date. For example, a company might be formed to take over a business upon the basis of a Balance Sheet at the 31st December, the new company being entitled to the profits as from that date, but the formation of the company might take some little time, and the certificate of incorporation might not be received until (say) the following 1st of March. In such circumstances, the intermediate profits, from the 31st December to the 1st March, represent capital and are not available for distribution as dividend. The reason is that these profits are included in the purchase price. In fixing the price, the vendors will have taken into account the fact as to whether the profits between the 31st December and the date of incorporation are to belong to them or to the purchasing company; if, as in this illustration, they are to belong to the latter, the purchase price will have been increased accordingly. Therefore, these profits have been

purchased and paid for out of the share capital of the new company, and if, when received, such profit were paid away as dividend, it would amount to a return to the shareholders of part of the capital they have themselves contributed.

If, as is customary, no accounts are taken at the date of incorporation it is always difficult to arrive at the amount of the profits that have to be treated as capital. If, for example, in the case above, the next accounts were prepared at the following 31st December, the better method would be to apportion the full year's profits between the two periods, before and after the 1st March, on the basis of the turnover for these two periods. Another method is to apportion on the basis of time, that is to say, in this case, that two months out of the twelve are prior to incorporation; therefore, one-sixth of the full year's profit is capital; but, as the profits earned in different periods of a year may vary considerably, this method, in many cases, is not a good one to adopt. The proportion of the full year's profit that is fixed as being prior to the date of incorporation should be transferred from Profit and Loss Account to the credit of a Capital Reserve Account, or used to write down preliminary expenses or goodwill. If any interest is paid to the vendors upon the purchase money, the interest for the period prior to the date of incorporation should be debited against the profits prior to that date, and any interest for the period after the date of incorporation should be debited to Profit and Loss Account.

In the above circumstances, an auditor should examine the whole facts most carefully, and see that the profits prior to the date of incorporation are ascertained as accurately as possible, and are not made available for dividend or used for revenue purposes.

Calls in Arrear.

If any calls have not been paid, a debit balance will appear upon the Call Account in the Impersonal Ledger,

and the details making up this balance will be ascertained by reference to the Share Ledger. These unpaid calls should be brought to the notice of the directors by the auditor, who should see that the total thereof is shown as a deduction from the issued capital in the Balance Sheet.

Calls Paid in Advance.

Any calls paid in advance should appear to the credit of a special account, or as credit balances upon Call Accounts, and the auditor should verify the details making up the total by reference to the Share Ledger. The total of the calls paid in advance should appear as a separate item in the Balance Sheet.

Forfeited Shares.

Shares may be forfeited for non-payment of calls, if express power to this effect is contained in the Articles. In cases where shares are forfeited in this way, an auditor must see that the Articles give the directors this power, and, further, that the provisions of the Articles have been carried out as regards giving the defaulting shareholder proper notices. The minute of the directors forfeiting the shares must be inspected, and it must be seen that the correct entries have been made in the financial books to record this transaction, and that the Share Ledger has been adjusted accordingly. The amount called up upon the shares forfeited must be debited to Share Capital Account and credited to a Forfeited Shares Account; and the debit balances upon the Call Accounts, which represent the calls due upon these shares but unpaid, should be written off to the debit of the Forfeited Shares Account; the latter account will then show a credit balance equalling and representing the amount paid up upon the shares forfeited. If these shares are re-issued at a discount, which can be done provided the discount does not exceed the amount already paid upon the shares by the old shareholder, any such discount should be debited to the

Forfeited Shares Account, and if, thereafter, this account shows a credit balance, this represents the final profit upon the forfeiture, which profit should be transferred to general reserve, or used to write down preliminary expenses or fixed assets. But there is nothing in the Companies Acts to prevent this profit being credited to Profit and Loss Account, subject, of course, to any restrictions provided in the Articles of the particular company. If, at the date of the Balance Sheet, the shares have not been re-issued, the auditor should see that the credit balance upon the Forfeited Shares Account is shown as a separate item in the Balance Sheet, being described as "amounts paid up upon shares forfeited."

Directors' Fees.

As regards the vouching of directors' fees, the Articles should be inspected and the provisions thereof carefully noted. The amount of the fees may be fixed by the Articles, or it may be left to the shareholders to vote the amount, in which latter case the shareholders' minute should be examined. On the other hand, directors are sometimes paid by the attendance, in which case the Directors' Attendance Book must be inspected, and the number of attendances of each director counted. The auditor should also examine the Register of Directors and Managers, to ascertain who are the directors of the company, and he should then see that each director receives only the amount properly due to him. Receipts should be obtained, though often endorsed cheques only are produced to the auditor, and if the signatures are known, these may be considered sufficient.

If the Income Tax upon the directors' fees has been paid by the company, such tax must be deducted from the fees when paying the directors, though nowadays, the directors are generally assessed for Income Tax direct in respect of their fees, in which case the company pays the fees in full. The Income Tax upon directors' fees must

never be borne by the company, unless the shareholders have voted the fees free of tax, and the total of the fee, plus the tax, is within the maximum fee (if any) provided for by the Articles.

Fees accrued but unpaid at the date of the Balance Sheet, must be provided for. Sometimes, in bad years, an auditor is informed that the directors have agreed to waive their fees, but even in these circumstances the auditor must insist upon such fees being either included in the accounts or referred to in his report, unless all the directors have voted upon and signed a minute, by which they all mutually agree to renounce formally all claim to their fees for the period of the accounts; otherwise, an agreement under seal with each director who has not signed the minute would be necessary. The auditor must, therefore, see that these requirements have been complied with.

If the directors are entitled to a percentage of the profits, the auditor should inspect the provisions of the Articles, by virtue of which such percentage is paid, and he should also see that the percentage is correctly calculated.

Directors' Expenses.

Directors are not entitled to their travelling expenses to attend board meetings, unless expressly allowed by the Articles, but they are entitled to proper expenses if travelling upon the business of the company, and in this latter case they should produce vouchers, and the amounts paid to them should be passed at the board meetings. The auditor, therefore, should inspect the receipts and the directors' minutes, seeing that the expenses appear to be reasonable.

Managing Director's Remuneration.

The Articles must give power to appoint a managing director, and such power is generally vested in the directors, who also fix the remuneration payable. The auditor must, therefore, inspect the Articles, and the minute of the

directors, seeing that the remuneration paid is in accordance therewith. If there is a contract with the managing director, this should be inspected.

Minute Books.

It is most important that an auditor should inspect both the directors' and the shareholders' minute books, for the minutes are the only authority for many of the transactions of a company, and, apart from this, by reading the minutes, an auditor often becomes aware of important matters that are taking place, and which should be provided for in the accounts, such as pending litigation in connection with disputed claims.

The following are examples of matters for which the shareholders' minutes are the authority—

Passing and adoption of the accounts.
Transfers to general reserve.
Declaration of dividends.
Appointment and remuneration of directors.
Appointment and remuneration of auditors.
The alteration of the Articles.

The following are examples of matters, to authorise which directors' minutes are necessary—

The issue of share capital.
Allotment of shares.
Calls.
The forfeiture of shares.
Adoption of contracts.
Appointment and remuneration of officials.
Declaration of interim dividends and, if authorised by the Articles, final preference dividends.
Appointment and remuneration of managing director.

Dividends.

The declaration of dividends is vested in the shareholders, except in the case of interim dividends, and in some cases the dividends upon preference shares, in both

of which cases the Articles sometimes expressly authorise the directors to declare these. Articles often provide that the directors shall recommend the dividends to be declared by the shareholders, and that the shareholders shall have no power to vote dividends in excess of those recommended by the directors. No entries must be made in the books or the accounts until after a dividend has been declared, and for this reason, dividends proposed by the directors must not be included in the accounts presented to the shareholders, except by way of a note. Immediately the dividends are declared by the shareholders, the entries must be passed through the books, for the dividend then becomes legally payable.

Interim Dividends. There must be express power in the Articles to declare interim dividends, and an auditor must, therefore, inspect the Articles and the directors' minute declaring the dividend. Before declaring, however, the directors must use reasonable care in order to satisfy themselves that such dividend is justified, and, for this purpose, accounts for the half-year or period should be prepared, full provision being made for depreciation, reserves for bad debts, and outstandings. The condition of trade, and the prospects of the coming half-year or period should be considered, for it is quite possible that the first half of the year may show a profit, which may be entirely swallowed up by a loss in the succeeding half-year, and it must be remembered that an interim dividend is on account of the full year's profits. It should also be seen that the company has sufficient cash available to justify the declaration of the dividend. If asked to advise as regards the declaration of an interim dividend, an auditor should go into all the circumstances most carefully, and see that proper accounts have been prepared, and that the whole position has been adequately considered.

Dividends on Preference Shares. The Articles sometimes give the directors power to declare the dividends upon the preference shares, in which case, again, they must

use every precaution to see that the accounts justify such dividends. If there is no such express power in the Articles, preference dividends, like dividends upon the ordinary shares, can only be declared by the shareholders.

Vouching Dividends. The auditor must inspect the minute declaring the dividend and see that the total paid agrees therewith. Income Tax must be deducted unless the dividend is declared "free of tax," but, in the former case, the gross amount of the dividend must be debited to Profit and Loss Account, and the tax deducted must be credited to the Income Tax Account, against the tax that will have been paid under the assessment made upon the company. The amounts paid to the various shareholders can be vouched with the returned and receipted dividend warrants.

Unpaid Dividends. If certain shareholders cannot be traced, the dividends declared and due to them should be credited to a special account, and shown separately on the Balance Sheet. The Articles sometimes fix a period after the expiration of which, if such dividends have not been claimed, they may be forfeited—but there must be express power to this effect, otherwise dividends do not become statute barred until the expiration of twenty years from the date of declaration, and the shareholder can claim them at any time within this period. Forfeited dividends should be transferred to general reserve, although, subject to the Articles, there is nothing to prevent a company crediting them to Profit and Loss Account.

Arrears of Cumulative Preference Dividends. If there are arrears of dividend upon cumulative preference shares, the amount of such arrears should be stated upon the Balance Sheet in the form of a note, but an auditor cannot insist upon this. No actual liability exists at date, and no liability will arise unless and until sufficient profits are made in the future, and, further, until the arrears of dividend are declared either by the directors or by the shareholders, according to the terms of the Articles. It will be

seen, therefore, that this is a question of the future. If and when sufficient profits are made, these arrears will have to be made up before there can be any dividend to the ordinary shareholders, and it will then be the duty of the auditor to see that this is done. But, in the meantime, it cannot be said that the Balance Sheet does not show a true and correct view of the state of affairs unless a note of the arrears of preference dividend is stated, for the Balance Sheet reveals the position of the company as a whole, whereas, the only purpose served by such a note is to show how the first profits which may become available for distribution in the future will be divided between the different classes of shareholders.

CHAPTER IX

PROFITS AVAILABLE FOR DIVIDEND

Profits Available for Dividend.

In the case of a company, the accounts are prepared by the directors, in whom also rests the power to recommend the dividends to be declared by the shareholders in general meeting. The shareholders appoint their auditor for the express purpose of ascertaining whether the accounts laid before them show the true and correct position of affairs, and, consequently, whether or not any profits, shown as available for distribution, have, in fact, been earned. The shareholders must of necessity depend almost entirely upon the auditor in this respect, and, therefore, it will be seen that the question of what profits are available for dividend is one with which an auditor constantly has to deal. It follows that it is essential that he should have a thorough knowledge of this most complicated question.

In Chapter IV it is shown that in most cases it is impossible to obtain absolute exactitude in ascertaining the profits of a business, because such profits are dependent upon the valuation of the assets of the concern. A true profit should be represented by a corresponding increase in the surplus of assets over liabilities, but as it is impossible in most cases to arrive at the exact value of all the assets, it is necessary that the value thereof should be estimated in accordance with certain accepted rules. Further, true profit is not arrived at unless the original capital, plus any additions thereto, is intact; therefore, if any part of such capital has been invested in assets that have depreciated in value by reason of the fact that they are of a wasting nature, or are in process of being consumed in

the course of earning revenue, or if, for any other reason, any part of the capital has been lost, then such wastage must be made good out of revenue before the true profits can be ascertained. However, the Companies Acts, 1908 and 1913, neither provide as to the exact manner in which the profits of a company are to be ascertained, nor enact that only "true profits" may be distributed as dividend. The periodical ascertainment of the profits of a business is an operation of such practical importance as to be essential to the safe conduct of the business itself, but to follow out the strict consequences of the above conception of profit in making out the annual accounts would often be very difficult in practice. Hence the strict meaning of the word "profit" is rarely observed in drawing up the accounts of firms and companies. These are domestic documents designed for the practical guidance of those interested, and so long as the principle on which they are drawn up is clear, their value is diminished little, if at all, by certain departures from the strict definition, which lessen greatly the difficulty of making them out. Hence certain assumptions have become so customary in drawing up Balance Sheets and Profit and Loss Accounts, that it may almost be said to require special circumstances to induce parties to depart from them.

It will be found that in some cases profits may be available for dividend, although the original capital of the company is not intact. In every individual case in practice, the provisions of the Memorandum and Articles of Association of a company are of the utmost importance when considering the question of the divisible profits. For if, when a company is formed, it is provided in its Articles that losses of capital shall be made good out of profits, and the method of ascertaining the profits available for distribution is precisely defined, these provisions will be compulsory in this particular case. If, on the other hand, the Articles provide that the original capital need not be kept intact out of current revenue, then in such a case

it may quite well be that a company could pay dividends out of *bonâ fide* trading profits, without replacing previous losses of capital. For, in such cases, it is with a knowledge, actual or presumed, of the terms of the Articles that shareholders have subscribed and that creditors have traded with the company; and although the payment of dividends might be deemed financially imprudent, the Companies Acts do not prohibit such a proceeding, and neither shareholders nor creditors can subsequently complain of what was one of the express intentions of the company.

From time to time circumstances of difficulty have arisen in practice in connection with the question of the profits available for dividend in particular cases, and have become matters of dispute between interested parties. As the Companies Acts are not definite upon this subject, the points in dispute have had to be submitted to the Courts for decision. In such cases, the whole of the circumstances are investigated, and the Court decides what is fair and equitable in the circumstances of the particular case. There are several very important cases that have been decided in this way, and the rules thus laid down are applicable in cases in which the circumstances are identical. But it must be borne in mind that the Courts decide any particular case entirely upon the circumstances of that case, and, further, that previous decisions may be reversed when a similar case comes before the Courts again. Therefore, the decided cases can be accepted only as an indication of what the Courts probably would decide in similar circumstances. Again, as the rulings in decided cases are not all entirely in accord with one another, it is extremely difficult to generalise upon this subject. However, two root principles are that the shareholders' capital may not be used to pay a dividend, and that a dividend can only be paid out of a *bonâ fide* surplus or profit. For example, if a company were to distribute the proceeds of sale of one of its fixed assets, such a dividend would be paid out of capital, and would

be in reality a return to the shareholders of part of the capital that they subscribed. If a company paid a dividend in spite of the fact that the Profit and Loss Account showed a loss, then, again, such dividend would have been paid out of capital, for there would be no surplus or profit available out of which it could be paid. If, in the accounts, the profits are overstated and the whole of such supposed profits have been distributed as dividend, the dividend must have been paid out of the shareholders' capital, to the extent to which the profits are overstated.

When arriving at the profits available for dividend, against the income of any period, there must, of course, be charged all the current expenditure that has been incurred in producing such income, but points of considerable difficulty arise in connection with the treatment of the depreciation of wasting assets and capital losses, and these will now be considered.

Capital Profits.

The surplus, or profit available for distribution as dividend, is not confined to revenue profits only, but in certain cases, may include capital profits. Suppose, for example, a fixed asset costing £1,500 is sold for £2,000, a clear surplus or profit of £500 has been made, and assuming that, apart from this, the share capital remains intact, this £500 could be distributed as dividend without violating the above principles.

Wasting Assets.

In the case of *Lee* v. *Neuchatel Asphalte Co.*, it was decided that where a company was formed to work a wasting asset, such as a mine, and its Articles specially stated that it was not necessary to provide for the depreciation of such wasting asset, there was nothing in the Companies Acts to compel it to do so.

In the case of mines, depreciation of the mine itself is not, in practice, usually provided for out of the current

profits, because ordinarily the object of a mining company is to work a particular mine only, and not to acquire and work other mines after the original one is exhausted. The life of the company is, therefore, roughly equal to the life of its principal asset, and when the latter is worked out the company will wind up.

The position, therefore, is a somewhat peculiar one, for it will be seen that the ore that is sold is part of the company's main capital asset, and that when the whole of the ore has been raised and sold the value of the mine is entirely exhausted, apart from any scrap value there may be in surface works and land. Ordinarily, the main object of such a company is to acquire this asset, sell the whole of the valuable part thereof—that is, the ore—and then to wind up. Now, what is the actual effect of providing for depreciation in such a case ? Out of the proceeds of the sale of ore will be paid all the expenses of raising the same, and all the expenses, losses and charges of the company ; and now, further, it is proposed to charge against each year's Profit and Loss Account a sum sufficient to accumulate, by the time the mine is worked out, the whole of the original capital sunk in acquiring and equipping the property ; therefore, if these provisions for depreciation are correctly estimated, then, when the company is finally wound up, the shareholders' capital will be returned to them in full.

During the life of the mine the whole of this capital which is gradually being accumulated is not required for the purposes of the business. If the company started with sufficient working capital, therefore, the whole of these accumulated funds must be invested outside the business, and so remain until the final winding up, when they will be realised and paid over to the shareholders. It will be seen that there is no asset requiring replacement, and that this question only affects the position upon final winding up. The whole of the amounts realised upon the sale of ore, after payment of all expenses, are payable to

the shareholders, but if depreciation is provided for, a proportion thereof will not be paid over as and when they are realised, but will be accumulated and only paid over at the end of the life of the mine.

Now, in practice, shareholders, as a rule, prefer that the whole of the earnings, after expenses have, of course, been deducted, should be paid over to them at once, and not that large sums should be accumulated in the hands of the directors. The original capital invested in the mine is regarded "as sunk and gone, and if the company retains assets sufficient to pay its debts, any excess of money obtained by working the property, over the cost of working it, may be divided amongst the shareholders." With each dividend the shareholders are in this way in effect obtaining a partial return of capital, and, therefore, individually, they should not regard the whole dividend as income, but should treat part as a return of capital, and re-invest that part. Upon winding up, of course, probably there will be no return to the shareholders, but they will look to the dividends paid during the life of the mine to repay to them their capital, and also to pay them for the use of the same.

It is suggested, therefore, that this is quite a reasonable business proposition, and it would appear that there is nothing in the Companies Acts to prevent a company adopting this policy, so that, if the shareholders decide on this course, and, for instance, provide to this effect in the Articles of the company, the law will not prevent them from doing so. If, on the other hand, they decide that the depreciation of the wasting asset shall be charged against profits, and provide to this effect in the Articles, then the company is bound to provide for such depreciation out of the current earnings before showing profits available for dividend; it will be seen that the whole matter, in these circumstances, rests in the hands of the shareholders, and it is the auditor's duty to see that the whole situation is made quite clear to them.

Depreciation of Plant and Machinery.

Before going further, it may be well to contrast the above position with that of a manufacturing company as regards the capital sunk in plant and machinery. In this latter case, it will be seen that the object of the company is *not* to continue only for the term of the life of the original plant, but to continue to trade more or less indefinitely. Therefore, in order to carry out this object, when the original machinery is worn out and useless, the same must be replaced, or the company cannot continue to trade. Therefore, out of the earnings of the original machinery, there must be provided a sum for the depreciation thereof, so that, during the period of its working life, the capital sunk is replaced, and, when the machinery is worn out, this sum is available to purchase the necessary new plant. Therefore, when *assets must be replaced* in order that a company may carry out its objects, the depreciation of such assets must be provided for.

Capital Losses.

Another very important case is *Verner* v. *General and Commercial Investment Trust.* In this case, the company owned various investments producing income, and the Profit and Loss Account showed a profit, but the value of the investments had seriously depreciated.

The question raised by this case was whether a company which had lost part of its capital could lawfully declare or pay a dividend without first making good the capital which had been lost; it was held that, although this course might sometimes be very imprudent, yet there was no law which prevented it in all cases and under all circumstances. Part of the judgment reads as follows—

"There is no law which prevents a company from sinking its capital in the purchase or production of a money-making property or undertaking, and in dividing the money annually yielded by it without preserving the capital sunk so as to be able to reproduce it intact either

before or after the winding up of the company. A company may be formed upon the principle that no dividends shall be declared unless the capital is kept undiminished, or a company may contract with its creditors to keep its capital or assets up to a given value. But, in the absence of some special Article or contract, there is no law to this effect, and, in my opinion, for very good reasons. It would, in my judgment, be most inexpedient to lay down a hard and fast rule which would prevent a flourishing company either not in debt or well able to pay its debts, from paying dividends so long as its capital sunk in creating the business was not represented by assets which would, if sold, reproduce in money the capital sunk. Even a sinking fund to replace lost capital by degrees, is not required by law."

It will be seen that the company, by declaring this dividend, is not paying the same *out of* the shareholders' capital, but is paying it *out of a "bonâ fide" revenue surplus*, but without providing for a *previous loss of capital*, which is quite a different matter; the point, therefore, is: Must losses of fixed capital be made good out of revenue, before profits are available for dividend? From this case, it would appear that the matter, again, rests with the shareholders. If the company provides that its capital must be kept intact before profits are available, then the company is bound to do so; but if the shareholders do not require their capital to be maintained out of revenue, then this course is not illegal, and, provided there are *bonâ fide* revenue surpluses, these are available for dividend.

But it must be observed that this case clearly holds that floating assets must be properly depreciated before arriving at the amount of the profits available for dividend, for part of the judgment reads as follows—

"Perhaps the shortest way of expressing the distinction which I am endeavouring to explain is to say that fixed capital may be sunk and lost, and yet that the excess of current receipts over current payments may be divided,

but that floating or circulating capital must be kept up, as otherwise it will enter into and form part of such excess, in which case to divide such excess without deducting the capital which forms part of it, will be contrary to law."

In the situation raised by the *Lee* v. *Neuchatel Asphalte Co.* case, it was shown that the non-provision for depreciation of the wasting asset was not such a bad business policy as at first sight it might appear, but with reference to capital losses, as in the *Verner* case, the same cannot be said Here, the company presumably was not formed with a view to trading only for a definite limited period, and, consequently, the non-provision for capital losses was unquestionably a bad financial policy; but this case would appear to show that there is nothing in the law to compel a company to run its business upon sound financial lines, so that if, for instance, a company provides in its Articles that it need not keep up capital out of revenue, then every shareholder subscribes upon this basis, and, consequently, there is nothing illegal in the company carrying out this policy.

Conclusions.

Some doubt has been thrown upon these cases by later ones, and it would, therefore, appear that there is not, and cannot be, any hard and fast rule that can be applied in practice as to what is capital and what is profit; and again, it is extremely difficult in many cases to decide exactly as to what is fixed and what is floating capital, though in theory the distinction is not so difficult. The conclusions, therefore, would appear to be that depreciation of floating assets must be provided for, but as regards fixed assets, it depends upon the objects of the company, the provision in its Articles, and the whole circumstances of the case. In fact, the position is that *some* companies need not provide for the depreciation of fixed assets, but the Court alone can definitely decide the question in any

particular case after all the circumstances have been considered.

A dividend pre-supposes a profit, and in the ordinary way this means a proper trading profit, but in some cases capital profits are also available, but only if they so clearly represent a capital surplus over and above the original share capital of the company, that if such capital surplus were paid away as dividend, the share capital would be left intact; therefore, it is necessary that the whole of the assets of the company shall be re-valued in order to ascertain that there is such a surplus, as a profit on one particular capital asset cannot be taken as available without regard to the value of the other assets. Further, such a capital profit must be a realised one, so that a mere increase in value of assets, which are, however, not sold, cannot be treated as profit available for dividend, for if it were so treated the effect must be that the dividend paid thereout is paid out of the working capital of the company; for this unrealised and estimated increase in value is not represented by a penny piece with which a dividend can be paid, and the working capital of the company is being used, possibly with serious effects to the concern. Even with trading profits it is extremely important to see that large unrealised profits are not credited and treated as available for dividend, for any dividend declared in respect of what are for the moment unrealised profits, must be paid in *cash*, with the result that the working capital of the company must be drawn upon. If, therefore, the company has not a large surplus of working capital, this may, and probably will, seriously strain its financial position.

The Interests of Creditors.

One of the main objects of the rule prohibiting the payment of dividends out of capital, is that the funds available to pay creditors must not be depleted by the payment to shareholders of improper dividends. Part of

the judgment in the case *Guinness* v. *Land Corporation of Ireland* reads as follows—

". . . the capital of the company as mentioned in the Memorandum is to be the fund which is to pay the creditors in the event of the company being wound up. From that it follows that whatever has been paid by a member cannot be returned to him. In my opinion, it also follows that what is described in the Memorandum as capital, cannot be diverted from the objects of the society. It is, of course, liable to be spent or lost in carrying on the business of the company, but no part of it can be returned to a member so as to take away from the fund to which the creditors have a right to look, as that out of which they are to be paid."

It will be seen, therefore, that, in the interests of the creditors, the capital of a company must be used exclusively for the purposes of carrying out the objects of the company. Such objects are set out in the Memorandum. Further, a dividend may be paid only out of a *bonâ fide* surplus or profit, as otherwise the capital available for the payment of creditors is reduced.

Position of the Auditor as Regards this Question.

As regards these matters, an auditor's position is one of considerable responsibility. He must go into the whole question and ascertain all the circumstances and facts of the case. He must, of course, be thoroughly conversant with all these rulings, and the principles arising out of the same, and see that these are properly applied, and, in any event, he must see that the whole position is made absolutely clear to the shareholders. If depreciation is not being provided for in respect of wasting assets, capital losses are not being provided for, and capital profits are being used for dividend purposes; in all these cases the shareholders are entitled to be placed in possession of all the facts of the case, and look to the auditor to see that

this is done. Of course, in practice, an auditor is often consulted by directors as to what may and what may not be done in these circumstances, and, therefore, it is of great importance that he shall have a complete grasp of the whole matter, as the responsibilities are great. Again, he may find it essential to act in direct opposition to the board, and this requires courage based upon a thorough knowledge of the subject, and appreciation of the responsibilities.

Summary.

To summarise, it would appear that, in arriving at the profits available for dividend, depreciation of floating assets must be provided for, in addition, of course, to all current expenses, charges and losses. As regards depreciation of fixed assets, this need not necessarily be provided for ; it depends upon the objects of the company, the terms of the Memorandum and Articles of Association, and the circumstances of the whole case, and, even after considering all these, the Courts alone can finally decide. Capital profits are available, subject to the following requirements : that the Memorandum and Articles allow, that they are actually realised profits, and that such profits remain after re-valuation of the whole of the assets.

CHAPTER X

THE LEGAL POSITION OF AUDITORS

The Legal Position of Auditors.

The subject of the exact legal position of auditors is one of some complexity and difficulty. The various Acts of Parliament dealing with the appointment of auditors are very indefinite as to the auditors' responsibilities and liabilities. There are several important cases dealing with the subject which indicate the legal view, but it is thought that finality has not yet been reached. Even in the accountancy profession, opinions differ; it is essential, therefore, that every auditor should give this matter most careful consideration, as each practitioner must, to a large extent, fix his own standard, but by acting up to a high sense of responsibility, the greatest service is rendered to the profession as a whole, and in the end to each individual member thereof. It is impossible in the space available, to deal exhaustively with this subject, but some of the most important cases will be briefly considered, and, thereafter, the conclusions to be drawn therefrom will be summarised.

The Position of an Auditor to a Private Firm.

In the case of private firms, an auditor is not appointed under any statute, but is responsible in damages if his employers suffer any loss through his neglect or default.

Auditor's Position under the Companies Acts.

Under the Companies (Consolidation) Act, 1908, Section 281, if an auditor in any report, certificate, Balance Sheet, or other document, makes a statement false in any material

particular, knowing it to be false, he is guilty of a misdemeanour, and is criminally liable, and, further, should he be convicted under this Section, this will not relieve him from his liability in addition to pay damages in respect of his default.

Under Section 215, Companies (Consolidation) Act, 1908, it is generally accepted that the Court has power to assess damages against an auditor, as an officer of the company, if he has been guilty of any breach of trust in relation to the company. This Section applies only where the company is in the course of being wound up.

Except for the above two Sections, the Companies Acts are silent as to the exact responsibilities of auditors in connection with the audit of the accounts of companies. But it would appear that, as the agent of the shareholders, an auditor must exercise reasonable care and skill in the carrying out of his duties, and that, if he fails and his clients suffer damage through his neglect or default, he is liable to them in damages. What is reasonable care and skill depends upon the whole of the circumstances of the particular case. But it must be pointed out that it is here that the whole difficulty of this question arises, for the circumstances of individual audits vary enormously, and there are no definite rules laid down as to the steps that an auditor should take before he is satisfied as to the correctness of a Balance Sheet. Further, there is no doubt that there is no uniform accepted practice in the accountancy profession, nor is it easy to see how there could be, except as regards general principles. The auditor must decide for himself in each case, as to what steps are necessary, and, for this purpose, an auditor must have considerable skill, knowledge and judgment. In this work an endeavour has been made to set down the general principles that should underlie every audit, in order that the auditor may comply with his moral and legal responsibilities, but it cannot be claimed that they represent the accepted practice of the profession.

An auditor is entitled to access to all the books, accounts and vouchers of the concern whose accounts he has to audit, and, in addition, he is entitled to such additional information and explanations as he may require. In the case of registered companies, these rights are given to him specifically by Section 113, Companies (Consolidation) Act, 1908, and his powers and the scope of his audit cannot be limited in any way by either directors or shareholders, but in the case of private firms the scope of an audit can be limited by agreement, in which case the auditor's responsibilities are limited accordingly; but in such circumstances, as is pointed out in Chapter I, it is of the utmost importance that the exact terms of the arrangement should be recorded in writing, otherwise difficulties may arise in the future.

Auditor's Liability for Neglect.

The liability of an auditor arises where it is proved that, through his neglect or default, his clients have suffered damage. This may arise, for example, where actual defalcations have taken place on the part of officers or employees of the concern, such as misappropriation of cash or stock. In the case of companies, the auditor's liability also may arise where the results shown by the accounts have been overstated, either through an error or by reason of deliberate falsification, resulting in the payment of dividends out of capital. This may be effected by over-estimating the value of assets, such as debtors and stock, by insufficient provisions for depreciation of other assets, or by the omission to provide for liabilities. In such cases, the auditor may be held personally liable, if it is proved that, had he exercised reasonable care and skill, he must have discovered the discrepancy.

Auditor's Liability as Regards Third Parties.

It must also be remembered that third parties may also be misled and thus suffer damage by reason of accounts

certified by an auditor ; for example, prospective creditors, debenture holders, investors, purchasers of the business, or intending partners may have produced to them the audited accounts of the business with which they are proposing to enter into business relations. However, from the case of *Le Lievre and Dennes* v. *Gould*, it would appear that, in the absence of fraud, an auditor would not be held liable to third parties who had suffered damage, even though he had been negligent. He is not employed by them and appears to owe them no duty. But a conscientious auditor should recognise a moral obligation towards third parties who otherwise may suffer through his neglect.

Legal Decisions.

There are several very important decisions upon this subject, all of which should be studied, but there is only space here to consider a few of the leading cases.

Leeds Estate Building, Etc., Society *v.* Shephard. In this case it was held that it is not sufficient for an auditor merely to compare the Balance Sheet with the books of account, and thus verify its arithmetical accuracy, but that he must satisfy himself that the Balance Sheet is a "true and accurate representation of the company's affairs." In this case the terms of the Articles had not been carried out, and it was held that "it was no excuse that the auditor had not seen the Articles when he knew of their existence." As a result of the auditor's neglect, dividends, directors' fees and bonuses were improperly paid, and he was, therefore, held liable for damages.

London and General Bank Case. In this case it was held that where an auditor does not report to the shareholders that the Balance Sheet is incorrectly drawn, knowing it to be the case, he is guilty of a misfeasance. In this case the company had advanced considerable sums to customers, but the securities held by the bank were wholly insufficient. The company had, however, taken

credit for the interest accrued due upon such loans, whereas the interest was never, in fact, paid. One of the chief causes of the bank's failure was the heavy loss in respect of these loans, and, had proper reserves been made for bad debts, no profits would have been shown available for dividend. The auditor apparently was aware of the real state of affairs, and reported fully to the directors, who, however, refused to alter the accounts. In his report to the shareholders, the auditor made no mention of the lack of security, etc., but merely stated, "The value of the assets as shown by the Balance Sheet is dependent upon realisation." The auditor was found guilty of a misfeasance, and was held jointly and severally liable with the directors in respect of two dividends declared, amounting to some £14,400 odd, on the ground that he ought to have reported the true facts to the shareholders, the words contained in his report to them being quite meaningless, and, therefore, he had failed in his duty, as a result of which failure the company had paid these dividends out of capital. Part of the judgment reads as follows—

"It is no part of an auditor's duty to give advice either to directors or shareholders as to what they ought to do. An auditor has nothing to do with the prudence or imprudence of making loans with or without security. It is nothing to him whether the business of a company is being conducted prudently or imprudently, profitably or unprofitably; it is nothing to him whether dividends are properly or improperly declared, provided he discharges his own duty to the shareholders. His business is to ascertain and state the true financial position of the company at the time of the audit, and his duty is confined to that. But then comes the question: How is he to ascertain such position? The answer is: By examining the books of the company. But he does not discharge his duty by doing this without enquiry and without taking any trouble to see that the books of the company themselves show the

company's true position. He must take reasonable care to ascertain that they do. Unless he does this, his duty will be worse than a farce. . . . An auditor, however, is not bound to do more than exercise reasonable care and skill in making enquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly show the true position of the company's affairs; he does not guarantee that his Balance Sheet is accurate according to the books of the company. If he did, he would be responsible for an error on his part, even if he were himself deceived, without any want of reasonable care on his part—say, by the fraudulent concealment of a book from him. His obligation is not so onerous as this.

"Such I take to be the duty of the auditor; he must be honest—that is, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true.

"What is reasonable care in any particular case must depend upon the circumstances of that case. Where there is nothing to excite suspicion, very little enquiry will be reasonable and sufficient; and, in practice, I believe, business men select a few cases haphazard, see that they are right, and assume that others like them are correct also. Where suspicion is aroused, more care is obviously necessary, but still an auditor is not bound to exercise more than reasonable care and skill even in a case of suspicion; and he is perfectly justified in acting on the opinion of an expert where special knowledge is required. . .

"The Balance Sheet and certificate of February, 1892, that is, for the year 1891, was accompanied by a report to the directors of the bank Taking the Balance Sheet, the certificate, and report together, Mr. Theobald stated to the directors the true financial position of the bank, and if this report had been laid before the shareholders, Mr. Theobald would have completely discharged his duty

to them. Unfortunately, however, this report was not laid before the shareholders, and it becomes necessary to consider the legal consequences to Mr. Theobald of this circumstance.

"A person whose duty it is to convey information to others, does not discharge that duty by simply giving them so much information as is calculated to induce them, or some of them, to ask for more. Information and means of information are by no means equivalent terms. . . . An auditor who gives shareholders means of information instead of information in respect of a company's financial position, does so at his peril, and runs the very serious risk of being held, judicially, to have failed to discharge his duty.

"In this case I have no hesitation in saying that Mr. Theobald did fail to discharge his duty to the shareholders in certifying and laying before them the Balance Sheet of February, 1892, without any reference to the report which he laid before the directors, and with no other warning than is conveyed by the words, 'the value of the assets as shown on the Balance Sheet is dependent upon realisation.' . . . It is a mere truism to say that the value of loans and securities depends upon their realisation. We are told that a statement to that effect is so unusual that the mere presence of those words is enough to excite suspicion. But, as already stated, the duty of an auditor is to convey information, not to arouse enquiry, and although an auditor might infer from an unusual statement that something was seriously wrong, it by no means follows that ordinary people would have their suspicions aroused by a similar statement, if, as in this case, its language expresses no more than any ordinary person would infer without it."

Irish Woollen Co. *v.* Tyson. In this case the auditor was held liable for damages where the accounts had been falsified by the suppression of invoices, it being held, that had he used reasonable care and skill, he should have

discovered the fraud. Part of the judgment reads as follows—

"For these reasons I am of opinion that if due care and skill had been exercised, the carrying over and the suppression of invoices would have been discovered, and the auditor is liable for any damage the company has sustained from the under-statement of liabilities in the Balance Sheet due to this cause since 4th January, 1892. I consider that not only are Mr. Kevans and his assistants not free from blame for this, but also for the mechanical way the audit was carried out."

London Oil Storage Co. *v.* Seear Hasluck & Co. In this case the auditors were held liable for damages, on the grounds that they had failed to verify the existence of the petty cash in hand, which according to the books amounted to £760, whereas, in fact, there was only £30, the difference representing the secretary's misappropriations.

The Kingston Cotton Mills Case. In this case the accounts had been falsified to a very considerable extent by the managing director, by means of extensive over-valuations of the stock. The stock had been certified by the managing director, and it was held on appeal that the auditor was entitled to accept such certificates, and that he was not liable in respect of the dividends that had been paid out of capital, as a result of the manipulation of the stock. Parts of the judgment read as follows—

"For several years frauds were committed by the manager, who, in order to bolster up the company and make it appear flourishing when it was the reverse, deliberately exaggerated both the quantities and values of the cotton and yarn in the company's mills. He did this at the end of the years 1890, 1891, 1892 and 1893. There was no book of account (except the stock journal, to which I will refer presently) showing the quantity or value of the cotton or yarn in the mill at any one time. . . . The auditors took the entry of the stock-in-trade at the beginning of the year, from the last preceding Balance Sheet,

and they took the values of the stock-in-trade at the end of the year from the stock journal. The book contained a series of accounts under various heads, purporting to show the quantities and values of the company's stock-in-trade at the end of each year, and a summary of all the accounts showing the total value of such stock-in-trade. The summary was signed by the manager, and the value as shown by it was adopted by the auditors and was inserted as an asset in the Balance Sheet, but 'as per manager's certificate.' The summary always corresponded with the accounts summarised, and the auditors ascertained that this was the case. But they did not examine further into the accuracy of the accounts summarised. The auditors did not profess to guarantee the correctness of this item. They assumed no responsibility for it. They took the item from the manager, and the entry in the Balance Sheet showed that they did so. I confess I cannot see that their omission to check his returns was a breach of their duty to the company. It is no part of an auditor's duty to take stock. No one contends that it is. He must rely on other people for details of the stock-in-trade in hand. In the case of a cotton mill, he must rely on some skilled person for the materials necessary to enable him to enter the stock-in-trade at its proper value in the Balance Sheet. In this case the auditors relied on the manager. He was a man of high character and of unquestioned competence. He was trusted by everyone who knew him. The learned Judge has held that the directors are not to be blamed for trusting him. The auditors had no suspicion that he was not to be trusted to give accurate information as to the stock-in-trade in hand, and they trusted him accordingly in that matter.

"It is the duty of an auditor to bring to bear on the work he has to perform that skill, care, and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care, and caution must depend on the particular circumstances of each case.

An auditor is not bound to be a detective, or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watch-dog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom, but in the absence of anything of that kind, he is only bound to be reasonably cautious and careful."

His Lordship then referred to the circumstances which led to the auditors being deceived, and came to the conclusion that they were not wanting in skill, care, or caution in accepting the figures of the manager, and he concluded as follows—

"The duties of auditors must not be rendered too onerous. Their work is responsible and laborious, and the remuneration moderate. I should be sorry to see the liability of auditors extended any further than in *In re The London and General Bank*. . . . Auditors must not be made liable for not tracking out ingenious and carefully laid schemes of fraud, when there is nothing to arouse their suspicion and when those frauds are perpetrated by tried servants of the company and are undetected for years by the directors. So to hold would make the position of an auditor intolerable."

From this case, therefore, it would appear that an auditor is entitled to rely upon the certificate of a responsible official as regards the stock-in-trade, but, in the author's opinion, an auditor would be running considerable risks if he acted too literally upon this decision. For, if the auditor were to accept, say, the manager's certificate, without in any way checking or testing the stock, the audit would be little short of a farce, for, although every other item in the Balance Sheet may be tested and checked

in every way, yet if the auditor merely relies upon a certificate as regards the stock, it means that the official responsible for the valuation of the stock can make the accounts show whatever results he pleases, by manipulating the stock, and the audit, therefore, in such circumstances, would be no guarantee at all that the accounts were correct, and would, therefore, in the case of a company, be no safeguard for the shareholders. In order, therefore, that the audit may be of some real value, the auditor must test the stock as far as is reasonably possible. In Chapter V, it is shown that there are many ways in which the stock may be tested; in fact, in some cases, it is possible to check the stock completely, but in others, especially where there are goods in course of manufacture, it is almost impossible for an auditor to satisfy himself completely as regards this asset. However, he can, and there is no doubt he should, make enquiries and use various tests, so that he can show, in the event of his being challenged, that he used every reasonable precaution, in order to satisfy himself as to the correctness of this most important item in the accounts.

For the foregoing reasons, a too literal construction should not be placed upon the ruling in the *Kingston Cotton Mill* case, but, in duty to his clients and to himself, an auditor in every case should investigate the stock most carefully, and apply thereto every reasonable test. Such investigations are of far greater importance than the mechanical checking upon which so many auditors expend such a large proportion of the time devoted to an audit.

Republic of Bolivia Exploration Syndicate, Ltd. Here it was held that auditors are *prima facie* responsible for *ultra vires* payments made on the faith of their Balance Sheets, but whether and to what extent they are responsible for not discovering and calling attention to the illegality of payments made prior to the audit, must depend upon the special circumstances of each case.

In this case certain payments were made, prior to the audit, for which there was no authority, this company being regulated by Table A (1906). Although these payments were *ultra vires*, the Court does not appear to have been satisfied that the company suffered actual damage through the auditor's default in not pointing out this fact in his report. Therefore, in the special circumstances of the case, the action against the auditors was dismissed, but without costs, as the Court appears to have been far from satisfied with the manner in which the audit was carried out.

Dumbell's Banking Co., Ltd. In this case the auditors, together with the directors, were prosecuted and sentenced to various terms of imprisonment, for concurring in the publishing of three Balance Sheets "which they knew to be false in material particulars, with intent to deceive and defraud the members, shareholders and creditors of Dumbell's Banking Company."

Wilde and Others *v.* Cape and Dalgleish. In this case the accountants were sued for negligence and breach of duty, the grounds being that they did not check the plaintiffs' Pass Book with the Cash Book, and thus failed to discover defalcations of the cashier, amounting to £1,700 odd. The point of the case was, as to whether or not the accountants were instructed to carry out a full audit. The case was settled by the accountants agreeing to judgment for £850. From this and various other cases, it will be seen how important it is that an auditor should have, in all cases, a clear and definite understanding with his clients as to what exactly he is to do, and what ground he is to cover, especially when only a partial audit is required, or where an accountant is instructed to carry out accountancy work only. Several accountants have had to pay damages in cases where the whole question has been as to what were the original instructions, and, therefore, what work they contracted to do.

Conclusions.

The conclusions to be drawn from the various cases upon this subject, would appear to be as follows—

(1) An auditor must honestly satisfy himself that the accounts show a true and correct view of the financial position of the concern whose accounts he is auditing.

(2) He must examine the books, and satisfy himself that the books are correct; therefore, for this purpose he must test the books with vouchers and original records, and make proper enquiries.

(3) It is not part of an auditor's duty to take stock, and he is entitled to rely upon the certificate of a responsible official, but he must exercise reasonable care and skill in testing the correctness of the stock.

(4) An auditor is entitled to rely upon the opinion of experts where special knowledge is required.

(5) An auditor need not necessarily be suspicious, but where his suspicions are aroused he must exercise all reasonable care and skill before he satisfies himself that all is in order.

(6) It is no part of an auditor's duty to give advice.

(7) If the auditor is not satisfied upon any material points, he must report clearly to the shareholders, in the case of a company, or to the partners in the case of a private firm.

(8) The auditor must verify the existence of assets, so far as is reasonably possible.

(9) In the case of a company, an auditor must see that the provisions of the Memorandum and Articles of Association are carried out.

(10) If an auditor is negligent or does not exercise proper care and skill, he may be held liable in damages if it is proved that his client has suffered losses which otherwise would have been prevented.

(11) As to what is reasonable care and skill depends

upon the circumstances of the case, and also upon the general standard adopted by the profession.

(12) In the case of private firms, it is of the utmost importance that the exact scope of the auditor's duties should be recorded in writing.

(13) Auditors will not be held liable for not tracking out ingenious and carefully laid schemes of fraud, when there is nothing to arouse their suspicion, and when these frauds have been perpetrated by tried servants of the concern.

(14) If an auditor wilfully certifies accounts, knowing them to be false, he may be held criminally liable.

In conclusion, it may be said that it is very unlikely that an auditor will be held personally liable provided he is possessed of the requisite professional skill, and that he honestly exercises such skill in all cases, taking every reasonable precaution to satisfy himself upon every point, before he certifies the accounts, and, in the event of his being dissatisfied upon any material point, if he reports clearly in his audit report to this effect. It is thought that no better short definition of an auditor's duties can be given than the following, which is part of the judgment in the *London and General Bank* case: "Such I take to be the duty of the auditor; he must be honest—that is, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true."

APPENDIX

EXAMINATION QUESTIONS

(1) WHAT are the principal objects of an audit ?

(2) State briefly the difference in principle between the audit of the accounts of a private partnership, and those of a limited company.

(3) What do you understand by a "Continuous Audit," and what are the advantages and disadvantages of such an audit ?

(4) Upon having been appointed auditor of (*a*) a company, (*b*) a partnership, what would you do in each case prior to commencing the actual work of the audit ?

(5) What are the objects of keeping an Audit Programme ?

(6) What do you understand by "Internal Checks," and what is an auditor's position in regard thereto ?

(7) What notes should an auditor make during the course of an audit ?

(8) What steps would you take to discover an error in the Trial Balance of a set of books, which the staff of the company had failed to detect, and which you were asked to find ?

(9) What do you understand by the term "Vouching" ?

(10) State in detail the work involved in a complete and efficient audit of the Cash Book of a manufacturing business.

(11) To what special points should an auditor pay attention when checking the Banker's Pass Book with the Cash Book ? State how you would verify the Balance at Bank and the Cash in Hand.

(12) Describe the steps that you would take as auditor to check the following—

Cash Sales.
Rents Receivable.
Interest Receivable on Loans.
Proceeds of sale of £500 Consols.

(13) Why would you consider endorsed cheques to be insufficient vouchers for the payment of accounts ? Under what circumstances would you accept endorsed cheques as vouchers for any payments ?

(14) In vouching a Cash Book you find the following payments. What proof would you require of the correctness of the payment in each case ?

Travellers' Commissions and Expenses.
Staff Salaries.

Payments to builders on account of a contract for the erection of buildings.

Purchase of Plant and Machinery.

Purchase of some Debentures of a Railway Company.

Payment of Bought Ledger Accounts.

(15) You are consulted as auditor of a manufacturing company, employing a large number of workmen, some of whom are day and some piece workers, as to the mode in which the wages should be recorded and the payment checked.

State what you would recommend under both heads, and, if the system you suggest were adopted, to what extent would you, as auditor, check the wages ?

(16) In what way would you audit a Petty Cash Account ?

(17) A firm of iron merchants, for whom you act as auditor, has contracted to purchase 5,000 tons of iron at £2 10s. per ton, on terms of six months acceptances from date of invoice. The iron had been delivered as follows—

15th April, 1914	2,000 tons
15th June, 1914	2,000 tons
15th October, 1914	1,000 tons

What books of the firm would it be requisite for you to see in examining the record of these transactions ? How would the liability in respect of it be shown in the Balance Sheet of 31st December, 1914 ?

(18) In auditing the accounts of a trading company, what steps would you, as auditor, take to ascertain if the amounts charged in respect of purchases were correct ?

(19) How would you satisfy yourself, as auditor, that the Reserve for Bad and Doubtful Debts was a sufficient one ?

(20) How would you vouch the entries contained in the Journal ?

(21) To what points should an auditor pay special attention when examining invoices ?

(22) Describe the steps that you would take to check the Bought Day Book.

(23) In auditing the accounts of a manufacturing business, you are asked particularly to ascertain that all outstanding accounts have been brought in. How would you satisfy yourself on this point ? Give illustrations

(24) What are the duties of auditors with reference to the grouping of the items in a Balance Sheet ? What evils have to be avoided ? What general principles should be acted upon ?

(25) What items would you expect to find in the " Trading Account," " Profit and Loss Account," and " Appropriation Account," and what are the objects of preparing these accounts ?

(26) Define a Balance Sheet, and explain why in the majority of cases it is not a Statement of Assets and Liabilities ?

(27) What do you understand by "Fixed" and "Floating" Assets, and upon what basis should they respectively be valued for Balance Sheet purposes?

(28) What are an auditor's responsibilities as regards the valuation of assets?

(29) What do you understand by "the Verification of Assets," and what are the objects of the same?

(30) State briefly how you would verify the following, and also what evidence you would require, as auditor, of the values of these assets in a limited company's Balance Sheet—

(*a*) Freehold Land and Premises.
(*b*) Fixed and Loose Plant.
(*c*) Inscribed Stocks.
(*d*) Goods on Consignment.
(*e*) Cash in Hand.
(*f*) Bonds to Bearer.
(*g*) Shares in Joint Stock Companies.

(31) Upon what principles should Stock-in-Trade be valued, and to what extent would you, as auditor, check the stock of a manufacturing company?

(32) In a brewery, 100 pockets of hops in stock cost £5 per pocket. How should they be stated in the Balance Sheet, if the present value be (*a*) £4 per pocket, or (*b*) £6 per pocket? Give your reasons.

(33) How should the Investments belonging to a company be valued for Balance Sheet purposes?

(34) In the Balance Sheet of a financial company there is the following asset—

"Investments, including Consols, English Railway Debentures and other Securities, £100,000."

You find, on enquiry, that the Consols and English Railway Debentures represent only a very small proportion of the £100,000, and that the "other securities" are altogether of a second-rate nature. What do you consider to be the duty of an auditor under these circumstances?

(35) A firm is in the habit of giving and taking a considerable number of "Bills Payable" and "Bills Receivable," and frequently discounts the latter. Four months elapse before the Balance Sheet is presented to you for audit. What steps would you take to verify the "Bills Payable" and "Receivable" existing at the date of the accounts?

(36) In examining the books of a company manufacturing stove grates, which closes its books on the 31st March, you observe three invoices respectively for pig iron, sand and fire bricks purchased, which had been entered in the Bought Day Book on the 22nd, 27th and 28th March, ruled through and entered on the 2nd April as purchases of the next financial year.

What would this suggest to you, and what steps would you

take to satisfy yourself that the Trading Account and Balance Sheet were correct ?

(37) The managing director of a limited company, manufacturing edged tools, skates and saws, requires to know at the end of each quarter whether the stock in each of the three departments has increased or diminished. An accurate stock-taking was made on the 30th June. How, without again taking stock, could you give him this information approximately on the 30th September, assuming that a proper Trading Account for each department had been kept during the previous year ?

(38) How would you verify the item " Work in Progress " appearing in a Balance Sheet ?

(39) Are there, in your opinion, any circumstances which would justify the addition of any anticipated profit to actual cost in the case of partially manufactured goods, or of an uncompleted engineering contract, or in similar cases ?

(40) How should Plant and Machinery be valued for Balance Sheet purposes in the case of a manufacturing company ?

(41) In the event of an auditor being of opinion that the provision for depreciation was insufficient, what course should he adopt ?

(42) On being appointed auditor of a company which has presented annual Balance Sheets to its shareholders for ten years, you find that some freehold buildings acquired at the formation of the company, and some buildings acquired five years later on a thirty years' lease, are taken credit for in the tenth annual Balance Sheet at the prices paid for the freehold and leasehold respectively. What course would you advise the directors to adopt with reference thereto, before you certify the eleventh Balance Sheet ?

(43) What is Goodwill, and upon what should it be based ?

(44) In auditing a Balance Sheet of a shipping company, you find a note on the Balance Sheet as follows : " Contingent Liability on Bills Receivable discounted, £5,000." What does this mean ? Is it necessary to verify this statement ? If so, how would you satisfy yourself on this point ?

(45) What do you understand by Depreciation, and what are the objects of providing for the same ?

(46) Explain what is meant by—

(*a*) A Specific Reserve.
(*b*) A General Reserve.
(*c*) A Reserve Fund.
(*d*) A Depreciation Fund.
(*e*) A Sinking Fund.

(47) The directors of a manufacturing company, owning a considerable quantity of valuable plant and machinery, decide to keep a Plant Register. They request you to advise them as to how this Register should be kept, what information

should be entered therein, and how the question of depreciation should be dealt with. Set out in the form of a report to the directors the advice that you would give.

(48) Having suggested the necessity of a provision for Depreciation of Machinery in the accounts of each of three companies, the respective boards of directors raise objection on the following grounds respectively—

(*a*) The cost of similar machinery having risen, nothing should be written off, as it is actually more valuable.

(*b*) Repairs done have fully maintained the machinery, which is as good as new.

(*c*) To charge depreciation to the same extent as in a good year would prevent the declaration of a dividend, with the result of dissatisfaction amongst the shareholders and a possible fall in the price of shares.

Criticise these arguments.

(49) In a manufacturing business, where the expenditure necessary to keep the works in proper order and efficiency varied very greatly from year to year, how could this expenditure be dealt with in the yearly accounts so that the profits available for dividend should not fluctuate greatly by reason of such expenditure being so variable ?

(50) As auditor of a company you find that, during the year, large sums have been expended on repairs, renewals, alterations, and additions to plant and machinery. How would you verify these payments, and by what principles would you be guided in deciding whether they were properly chargeable to capital or revenue ?

(51) What are the various methods used in practice for writing off depreciation ? Shortly describe each.

(52) What do you understand by Secret Reserves, and what is an auditor's position in regard thereto ?

(53) What are the provisions of the Companies (Consolidation) Act, 1908, with reference to the appointment and remuneration of auditors ?

(54) Set out the powers and duties of auditors under Section 113 of the Companies (Consolidation) Act, 1908, and the directions contained in that clause with regard to the Auditor's Report.

(55) Having completed the audit of a company's Balance Sheet, and having found everything in order, give a copy of your report to the shareholders in accordance with the Companies (Consolidation) Act, 1908.

(56) What are the requirements of the Companies (Consolidation) Act, 1908, with reference to the statement in the form of a Balance Sheet required to be filed with the Annual Summary ?

(57) A company registered under the Companies Acts, 1908 to 1917, has issued shares for the purpose of raising

money to defray the expenses of the construction of some works, which will not be able to earn income for three years. The directors are of opinion it is not desirable to charge interest on such shares against the Profit and Loss Account, but treat such interest as capital expenditure. What steps must the directors take to satisfy you, as auditor, before you agree to certify the accounts without comment ?

(58) What particulars have to be entered in a Register of Mortgages under the Companies (Consolidation) Act, 1908 ?

(59) You are appointed auditor on the formation of a limited company, and are instructed to examine the books for the purpose of certifying the particulars required for the Statutory Report under the Companies (Consolidation) Act, 1908. What steps would you take to enable you to give the necessary certificate ? Give the form of certificate.

(60) When a company has not adopted a good system of account keeping, has an auditor any special duty to perform ? Does the Companies (Consolidation) Act, 1908, confer any special power upon an auditor in this respect ?

(61) Is an auditor entitled to examine the Minute Books of a company, and, if so, for what reasons ?

(62) Can Shares and Debentures be issued at a discount, and, if so, how should the discount be dealt with in the accounts ?

(63) For what purposes should an auditor refer to the Memorandum and Articles of Association of a company ?

(64) The directors of a company of which you are auditor, instruct you to audit once a fortnight the documents and entries in connection with the transfer of the company's shares. Set out fully what your duties are.

(65) How should "forfeited" shares be treated in the published accounts of a company ?

(66) What do you understand by "Debentures issued as collateral security for a Loan," and how should this position be shown in the Balance Sheet ?

(67) What are the duties of an auditor of a company under the Companies (Consolidation) Act, 1908, in respect of the item "Preliminary and Formation Expenses," and how should the same be dealt with in the accounts of a company ?

(68) A limited company was formed and incorporated on the 1st November, 1914, to acquire two private concerns as on the 30th June, 1914, adopting their trading from that date. The purchases were completed on the 30th November, 1914. It was decided to keep the accounts of the two businesses separate until the 30th June, 1915. The net profits at that date were found to be £2,100 and £3,600 respectively for the year. You are asked to advise the directors as to the amount of dividend they are justified, apart from financial considerations, in paying on the company's total capital of £50,000 in ordinary shares.

What points for consideration would this involve ?

(69) In auditing the accounts of a limited company, you find debited to the Profit and Loss Account, "Directors' Fees and their travelling expenses, £653 17s. 6d." How would you satisfy yourself that this charge is correct ?

(70) The directors of a company for which you are auditor consult you with regard to the payment of an Interim Dividend. State the points which would guide you in forming an opinion, and what information you would require before advising.

(71) The Bulgarian Oil Company is a limited company, of which the capital is divided into Ordinary and Preference Shares, the latter carrying a cumulative dividend of 6 per cent. per annum. For several years the company carried on business successfully and paid its Preference dividends and also considerable dividends to Ordinary shareholders. At 30th June, 1914, it had an accumulative fund of undivided profits. During the year ended 30th June, 1915, no profits were made, and the accumulated fund was absorbed, leaving a small deficit, but this was not ascertained until the accounts were made up the following September. On 1st July, 1915, the directors paid to the Preference shareholders their usual dividend at the rate of 6 per cent. per annum.

Give your views as to the correctness, or otherwise, of this action, and of the duty (if any) devolving on the auditor in connection therewith.

(72) With regard to Preference Shares, what is meant when they are "Cumulative" as to dividends? How should arrears of "Cumulative Preference dividend" be dealt with in the accounts of the company ?

(73) How should unclaimed dividends be dealt with in the yearly Balance Sheets of a company ?

(74) A limited company has a nominal capital of £50,000 in £1 Ordinary Shares.

10,000 shares were allotted to the vendors as fully paid.

35,000 shares were subscribed by the public and have been called up to the extent of 10s. per share. Of these, 400 shares, upon which 2s. 6d. per share only has been paid up, have been forfeited, and 400 shares have calls unpaid of 5s. per share.

State the capital of the company as it should appear in the published Balance Sheet.

(75) The directors of a trading company present to their shareholders a Statement of Receipts and Payments only, and, on the strength of a surplus shown on this statement, resolve to pay a dividend absorbing nearly the whole of the surplus. Point out the risk they run of its being eventually declared that such dividend has not been earned and has, therefore, been paid out of capital.

(76) In the case of a newly formed company, set out in

detail the extent to which you would check the issue of shares.

(77) A company issues £40,000 debentures, such debentures being redeemable at the end of ten years at 105. It is decided to create a Sinking Fund to provide for the repayment of the debentures and the premium. How should these transactions be dealt with in the accounts, and what will be the position at the end of the period when the debentures have been repaid ?

(78) In what circumstances is it lawful for a company to pay commission to any person in consideration of his subscribing or procuring subscriptions for shares, and how should such payments be dealt with in the accounts ?

(79) Is a company formed to work a wasting property bound to set apart a Sinking Fund to meet the depreciation of such property, and what is the legal position of an auditor of such a company in this connection, and what are his duties ?

(80) It is often stated that " Dividends have been paid out of Capital." What is meant by this statement, and how can dividends be so paid out of capital ?

(81) In the case of a manufacturing company, what is the legal position as regards the depreciation of plant and machinery ?

(82) In the event of a company issuing shares at a premium, how should the premium be treated in the accounts, and is it available for dividend purposes ?

(83) If there are not sufficient profits to pay the dividends on the Preference Shares, how should the arrears be dealt with in the accounts of a company ?

(84) Is a company bound to replace lost capital out of revenue before it can declare dividends ? State fully the reason for your answer.

(85) If the directors of a company informed you that, owing to bad trade, they did not intend to draw their fees, what course would you adopt ?

(86) The market value of the Investments of a trust company has fallen considerably, while the company has earned enough income to pay the usual dividend. How should you deal with this position of affairs in auditing the annual accounts ?

(87) The directors of a company, limited by shares, have issued capital at a premium. They are, under the constitution of the company, bound to provide for depreciation in respect of wasting assets out of revenue, and only entitled to declare dividends out of the profits of the company. You are told that the Board have been advised that they cannot carry the premiums received to Revenue Account, and they have, therefore, decided to show the amount as a separate item on the liabilities side of the Balance Sheet, and apply one-tenth of it annually in aid of depreciation of leaseholds. What is

your duty as auditor in these circumstances? Give your reasons.

(88) Are capital profits available for distribution as dividend?

(89) Is an auditor personally liable if it is subsequently proved that the accounts he has certified are false or fraudulent?

(90) An engineering company has built a new workshop and equipped it with new lathes. A portion of the work has been done by the company's own men, and a portion by outside contractors. The addition has rendered it needful to provide increased steam power, and, consequently, an old engine has been sold and been replaced by a larger one purchased. State what evidence you would require, as auditor, that the amounts charged to Buildings Account and Plant Account were correct, and how the cost of the additional steam power should be dealt with.

(91) A limited company has removed its business to new works which have cost, including Freehold Land, £30,000. A portion of the machinery and plant, at an estimated value of £14,000, has been removed to the new works at a cost of £1,800. The remainder has been sold, showing a loss on the total book value of the machinery and plant of £3,200. The profits for the year, including the balance brought forward from the previous year, after making provision for depreciation on the machinery and plant are £4,500, without taking into account the above-named loss, and are about the normal profits in previous years.

State your views as to the proper mode of dealing with the cost of removal and the loss on the sale, and whether, apart from financial considerations, the directors would be justified in declaring a dividend.

(92) As regards the legal liabilities of auditors, is there any difference between the position of an auditor to a partnership, and an auditor appointed under the Companies Acts?

(93) To what extent is an auditor responsible for the valuation of the Stock-in-Trade?

(94) The trading profits of a manufacturing concern for a year in which the sales have equalled the average of past years show a considerable reduction on preceding years. You are asked to investigate and report to the partners the reasons for this reduction in profits.

State what are the points to which you would give attention, and how you would proceed to investigate them.

(95) In auditing the accounts of a charitable institution, where a paid secretary is employed, who is authorised to collect and give receipts for donations and subscriptions, what information and evidence would you require before certifying the Annual Accounts, to satisfy yourself that all the subscriptions and donations had been properly accounted

for, and what safeguards would you suggest to ensure this ?

(96) A company desirous of extending its premises, obtains estimates for the work from builders, the lowest of which is £4,000. On consideration of the circumstances, the directors of the company decide to carry out the work by means of their own staff, and the additional premises figure in their Balance Sheet at £4,000, made up as follows—

	£
Net cost of materials purchased	1,300
Discount thereon transferred to Interest and Discount Account	30
Labour on erection	2,240
Managing director's supervision (part of his annual salary)	100
Proportion of office expenses	50
Interest on outlay to date of completion	40
Profit, transferred to Profit and Loss Account.	240
	£4,000

What view should an auditor take of this transaction and of the various items involved ?

(97) In examining the Cash Book of Smith & Brown, you find the following item among the payments—

1913.		
Aug. 20	Jones & Co., for coal . . .	£42 10 0

The receipt on the file corresponding in order to this item reads as follows—

MR. A. WILLIAMS. *Dr. to* JONES & Co.

For coal supplied to 31st July, 1913 . . . £42 10 0

Received 31st August, 1913,

(Stamp) With thanks,

J. ROBINS.

In what particulars does this appear to be an insufficient voucher ?

(98) In examining a list of Debtors and Creditors with the Ledger Accounts for the purposes of a Balance Sheet, to what features of each account should you pay attention, apart from the mere arithmetical correctness of the extractions ? Give examples of error or fraud which may be detected in this process.

(99) Blank & Co. keep all Bills Receivable in their hands until maturity, and then pay them into the Bank for collection. On 31st July, when you are examining the Balance Sheet of 30th June, it appears that the actual bills in the cash box

are in total £1,000 less than the amount shown by the Ledger Account of Bills Receivable on 30th June, and it is explained to you that one of the bills then in hand (for £1,000) has matured during July. What entries would you expect to find in the July Cash Book as to this £1,000, and to what examination would you subject them before concluding that the matter was in order ?

(100) In what way does the omission of liabilities affect—

(*a*) The Profit and Loss Account.

(*b*) The Balance Sheet ?

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